TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 287

THE UNITED STATES, PETITIONER,

vs.

HUNTINGTON BEACH COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION FOR CERTIORARI FILED AUGUST 2, 1955

CERTIORARI GRANTED OCTOBER 10, 1955

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

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THE UNITED STATES, PETITIONER,

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HUNTINGTON BEACH COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

INDEX

	Original	Print
Record from the United States Court of Claims	1	1
Petition	1	1
Exhibit "A"—Claim for refund of corporation income tax	13	6
Exhibit "B"—Letter disallowing claim for refund	16	9
Answer	17	9
Agreed statement of facts	19	10
Exhibit 4—Notice of intention of State Lands Commission to receive offers to enter into an agreement or agreements for extraction of oil and gas and other hydrocarbons from certain tide and submerged lands of the State, situate in Orange County, California	29	16
Exhibit 5—Permit dated August 25, 1938 between Huntington Beach Company, et al. and Southwest Exploration Company	31	18
Exhibit 6—Agreement dated August 25, 1938 between Huntington Beach Company, et al. and Southwest Exploration Company	36	23
Exhibit 7—Letter dated August 30, 1938 from Southwest Exploration Company to State Lands Commission	44	27
Exhibit 8—Agreement for easement No. 392	45	28

west in the two agreements entered into on August 25, 1938. Under said agreements as supplemented by the September 27, 1938, agreement, Southwest agreed to pay taxpayer, as one of the upland owners, an amount equal to 17.75 per cent of the net profits from the extraction of oil and gas from the wells covered by State Easement No. 392.

(b) The agreement contained provisions for the calculation of the net profits. These net profits were defined as the gross proceeds from Southwest's operations on a designated portion of the State lands, minus chargeable expenses. The gross proceeds included the sale value of all oil produced and saved, all gas produced and sold, and 50 per cent of all gasoline extracted from gas, minus State reserves, plus proceeds of rental, etc., the cost of which had been a chargeable expense. The chargeable expenses embraced all normal operating costs. All surface operations during the period herein material in connection with drilling and operation of the wells covered by State Easement No. 392 were conducted on the land owned by taxpayer. Plaintiff alleges that the property owned by said plaintiff adjacent to the area of the State Easement constituted a part of the mineral property thereof inasmuch as the surface and subsurface of plaintiff's property was necessary for purposes of mineral extraction from the said State Easement.

8. (a) During the taxable year here involved taxpayer received total payments from Southwest on account of its share of the net profits from production of oil and gas from the wells located
9 on plaintiff's land covered by the above-mentioned State Easement in the amount of $1,298,222.85. In preparing its corporate income tax return for the taxable year 1948, plaintiff claimed percentage depletion on the above-mentioned payments from Southwest in the amount of $357,011.28.

(b) Plaintiff alleges that by reason of the facts alleged herein it possessed an economic interest in the oil and gas in place in respect of State Easement No. 392 and in the production therefrom, and further alleges that it is entitled to the statutory deduction for percentage depletion equal to 27½ per cent of the net profits of Southwest due plaintiff for the taxable year 1948.

(c) Defendant's disallowance of percentage depletion to plaintiff for the taxable year 1948 in the amount of $357,011.28 was erroneous and resulted in an overstatement of plaintiff's taxable income in that amount.

(d) As a result of the said erroneous disallowance by defendant of the deduction for percentage depletion in the manner hereinbefore alleged for the taxable year here involved in the amount of $357,011.28, plaintiff overpaid its Federal income tax liability for said taxable year in the amount of $135,664.29, plus statutory interest

of $47,138.69 thereon, as set forth in its timely claim for refund, annexed hereto as Exhibit A.

(e) No action is now pending or has ever been taken on plaintiff's claim by Congress, or by any department of defendant or in any judicial proceedings other than the above-entitled proceedings in this Court.

(f) Plaintiff is now and has always been the sole owner of the claim herein referred to and has made no transfer or assignment of the aforesaid claim or any part thereof, or any interest therein. No part of any sum representing the instant claim, which was collected by defendant from plaintiff as aforesaid by the Collector of Internal Revenue for the First District of California, has been refunded, repaid or credited to plaintiff, and the whole thereof, with interest thereon according to law, remains due and owing from defendant to plaintiff.

(g) The following provisions of Federal statutes are relied upon, among others, by plaintiff:

I.R.C. of 1939, sec. 23(m), 26 U.S.C. 23(m);
I.R.C. of 1939, sec. 114(b)(3), 26 U.S.C. 114(b)(3);
I.R.C. of 1939, sec. 114(b)(4), 26 U.S.C. 114(b)(4);
I.R.C. of 1939, sec. 3771, 26 U.S.C. 3771;
I.R.C. of 1939, sec. 3772, 26 U.S.C. 3772;
I.R.C. of 1954, sec. 6511, — U.S.C. —;
I.R.C. of 1954, sec. 6611(a), — U.S.C. —;
I.R.C. of 1954, sec. 7422(a), — U.S.C. —.

Wherefore, plaintiff demands:

(a) Judgment in the principal amount of one hundred thirty-five thousand six hundred sixty-four and twenty-nine hundredths dollars ($135,664.29), plus interest in the total amount of forty-seven thousand one hundred thirty-eight and sixty-nine hundredths dollars ($47,138.69) paid to defendant by plaintiff on account of plaintiff's revised income tax liability as aforesaid for the taxable year ended December 31, 1948, plus interest upon said total amounts at six per cent (6%) per annum as provided by law;

(b) Such other and further relief to which it may appear the plaintiff is justly entitled.

Dated, January 7, 1955.

SIGVALD NIELSON,
HARRY R. HORROW,
W. J. MCFARLAND,
Attorneys for Plaintiff.

PILLSBURY, MADISON & SUTRO,
Of Counsel.

(Here follow 2 photos, fols. 12, 12a)

	Original	Print
ord from the United States Court of Claims—Continued		
eed statement of facts—Continued		
ibits—Continued		
Exhibit 9—Huntington Beach Offshore Area-map of main zone	65	42
Exhibit 10—Huntington Beach Offshore Area-map of Jones Zone	66	42
Exhibit 11—Agreement dated September 27, 1938 between Southwest Exploration Company and and Pacific Electric Railway Company, et al.	67	43
Exhibit 12—Amendment to agreement for easement No. 392	77	52
Exhibit 13—Amendment to agreement for easement No. 392	78	53
Exhibit 14—Diagrammatic chart and chart showing illustrating courses of wells surfaced on Huntington Beach Uplands, etc.	80	54
Exhibit 15—Statement of income and expense of Southwest Exploration Company from state easement No. 392 and Huntington Beach Company share of the net income	82	55
Argument and submission of case	83	56
Opinion, Madden, J.	84	56
Concurring opinion, Jones, C. J.	91	62
Findings of fact	92	62
Conclusion of law	100	70
Clerk's certificate (omitted in printing)	101	
er allowing certiorari	102	70

1 In the United States Court of Claims

Docket No. 18-55

HUNTINGTON BEACH COMPANY, A CORPORATION, PLAINTIFF

vs.

THE UNITED STATES OF AMERICA, DEFENDANT

PETITION—Filed January 11, 1955

To the Honorable the United States Court of Claims:

Huntington Beach Company, a corporation, plaintiff herein, complaining of defendant, respectfully shows unto the Court and alleges as follows:

1. At all times stated herein plaintiff was and now is a corporation duly organized and existing under the laws of the State of California. Its principal office is located at 225 Bush Street, San Francisco 4, California.

2. This is a suit of a civil nature, to recover moneys (and interest thereon) alleged by plaintiff to have been erroneously and illegally collected from it by defendant, acting by and through its District Director of Internal Revenue for the First District of California, herein referred to as "District Director" (formerly designated the Collector of Internal Revenue), as corporation income tax for the taxable year ended December 31, 1948. Such tax was imposed under the laws of the United States of America, and, on account thereof, this is a case arising under the Constitution of the United States and the Acts of Congress thereunto pertaining, particularly Chapter 1 of the Internal Revenue Code of 1939, as amended (Act of October 8, 1940, c. 757, 54 Stat. 974, as amended), over which this Court has jurisdiction as provided in section 1491 of Title 28 of the United States Code.

3. (a) On or about May 31, 1949, plaintiff duly filed with the Collector of Internal Revenue, First District of California, herein referred to as "Collector," its corporate rate income tax return for the taxable year ended December 31, 1948, prepared in accordance with the accrual method of accounting.

(b) In its corporate income tax return for the taxable year ended December 31, 1948, plaintiff reported ordinary net income in the amount of $1,908,703.91. In arriving at said amount of ordinary net income, for normal tax and surtax purposes, plaintiff deducted the amount of $357,011.28 on account of percentage depletion upon payments it received from Southwest Exploration Company, a corporation, hereinafter referred to as "Southwest," representing

plaintiff's share of the net profits during the taxable year of oil and gas production from tidelands operated by Southwest.

(c) On the basis of the foregoing, in its corporate income tax return for the taxable year ended December 31, 1948, plaintiff computed and disclosed its corporate income tax liability for
3 such year in the total amount of $724,802.72. The amount of its Federal income tax liability as disclosed by its return was paid to the Collector as follows:

Date of Payment	Income Tax Paid
March 11, 1949	$182,500.00
May 31, 1949	179,901.36
September 15, 1949	181,200.68
December 14, 1949	181,200.68
Total	$724,802.72

(d) All of said amounts were duly and timely paid by plaintiff to the Collector

4. (a) On December 13, 1950, the Internal Revenue Agent in Charge, San Francisco, California, acting on behalf of the Commissioner of Internal Revenue, upon audit and review of plaintiff's income tax return for the taxable year 1948, proposed an additional income tax liability for said taxable year in the amount of $457.54, as set forth in his letter to plaintiff dated December 13, 1950. All of said amount of additional income tax in the amount of $457.54 for said taxable year was duly paid by plaintiff, together with interest thereon, to the Collector on February 21, 1951.

(b) Upon subsequent audit and review of plaintiff's income tax return for the taxable year 1948, the District Director proposed an additional income tax liability for said taxable year in the amount of $135,664.29. On December 30, 1954, plaintiff executed on Treasury Department form 870 its consent to the assessment and collection of said amount of additional corporate income tax for
4 the taxable year involved and on December 30, 1954, duly paid to the District Director all of said amount of additional income tax in the amount of $135,664.29, together with statutory interest thereon in the amount of $47,138.69.

(c) The aforesaid additional income tax liability of $135,664.29, as determined by defendant, was based upon the erroneous disallowance of percentage depletion as claimed by petitioner upon the net profit payments received by petitioner from Southwest during the taxable year here involved. In paying the amount of the additional income tax as aforesaid, plaintiff retained the right to contend, by claim for refund or otherwise, that it was not liable for said amount of additional income tax and interest and that it was

entitled to an allowance for percentage depletion on payments received from Southwest during the taxable year.

(d) The collection of the foregoing amount of $135,664.29 and interest thereon in the amount of $47,138.69 by defendant, through the District Director, was erroneous, illegal and excessive.

5. (a) On or about January 3, 1955, plaintiff duly filed with the District Director a verified claim for refund of income tax for the taxable year ended December 31, 1948, in the amount of $135,664.29, plus interest thereon of $47,138.69, together with interest on said amounts as allowed by law.

(b) Said claim was based upon defendant's erroneous disallowance of percentage depletion claimed by plaintiff in the amount of $357,011.28 on net profit payments totaling $1,298,222.85 received from Southwest during the said taxable year 1948.

(c) Attached hereto and made a part hereof as if set forth at length herein is a true copy of said claim, marked "Exhibit A."

6. (a) In accordance with the provisions of section 3772(a)(2) of the Internal Revenue Code of 1939, the Commissioner of Internal Revenue notified plaintiff of the disallowance of its aforesaid claim by registered letter dated January 4, 1955.

(b) Attached hereto and made a part hereof as if set forth at length herein is a copy of said notice of disallowance, marked "Exhibit B."

(c) It was improper and erroneous for the Commissioner of Internal Revenue to reject plaintiff's claim aforesaid.

7. (a) In 1938 the State of California passed the State Lands Act of 1938 to control the exploitation of oil deposits in the State tidelands. The Act provided that any lease of submerged State land had to contain a provision that each well drilled pursuant to the terms of such lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tidelands or submerged lands covered by the lease. The lease was further required to provide that all the ordinary facilities, including field offices, settling tanks, pipe lines, the tops of all wells, and other equipment and appliances required in connection with the production of oil and gas be located on, and all surface operations be conducted from, such filled lands or uplands.

(b) From August 8 to 13, 1938, the State Lands Commission published a notice entitled "Notice of Intention of State Lands Commission to Receive Offers to Enter into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State Situated in

Orange County, California." The area covered by the above-mentioned notice of intention consisted of approximately 835 acres of submerged land lying off Huntington Beach, California. There were no filled lands usable or available in connection with the extraction of oil and gas from this area.

(c) The notice of intention required that each bidder, as a condition precedent to consideration of his bid, present satisfactory evidence of his ability to furnish all necessary sites and rights of way. This evidence had to include (1) an endorsement by the owners of the uplands on the proposed agreement acknowledging that the bidder had the necessary sites, rights of way and easements, and (2) the originals or copies of the instruments vesting in the bidder the necessary sites, rights of way and easements.

(d) On August 25, 1938, taxpayer, as one of the owners of the uplands adjacent to the 835 acres of submerged land covered by the notice and in conjunction with the other owners of the uplands involved herein, entered into an agreement with Southwest. Under this agreement Southwest was permitted to go on the uplands, to open the tops of its oil wells from the uplands, to drill in
7 and under the uplands, and to place its machinery on the surface of the uplands. A second agreement was entered into on the same day between the upland owners and Southwest covering the surface location and subsurface course of the wells to be drilled through the uplands.

(e) On August 30, 1938, Southwest submitted its bid to the State Lands Commission. It annexed to its bid a form entitled "Agreement for State Easement" which bore the endorsement of each of the upland owners that Southwest had been granted all necessary rights of way and easements in and through the uplands necessary for the performance of the terms, conditions and covenants required and imposed upon Southwest by the terms of the "Agreement for State Easement." Attached to Southwest's bid also was the agreement entered into by it on August 25, 1938, with taxpayer and the other upland owners giving Southwest permission to use the uplands for its drilling operations.

(f) On September 26, 1938, Southwest's bid was accepted and it entered into an agreement entitled "Agreement for State Easement No. 392" with California. This agreement, as required by the State Lands Act of 1938, contained, inter alia, a provision requiring all wells to be slant drilled from the uplands and required all machinery to be located on and all operations to be conducted from such uplands.

(g) On September 27, 1938, Southwest entered into an agreement supplementing the prior agreements of August 25, 1938, with the upland owners which was entered into in order to provide
8 a manner of computation and distribution of rental for the rights and privileges given by the upland owners to South-

Form 843
U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
(Revised June 1951)

EXHIBIT A to Petition

CLAIM

TO BE FILED WITH THE DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

DIST. DIRECTOR, INTERNAL REVENUE AUDIT DIV.
RECEIVED
JAN 3 1955
San Francisco

DIRECTOR'S STAMP

(Date received)

The Director will indicate in the block below the kind of claim filed, and fill in, where required, the certificate on the back of this form.

[X] REFUND OF TAXES ILLEGALLY, ERRONEOUSLY, OR EXCESSIVELY COLLECTED.

[ ] REFUND OF AMOUNT PAID FOR STAMPS UNUSED, OR USED IN ERROR OR EXCESS.

[ ] ABATEMENT OF TAX ASSESSED (not applicable to estate, gift, or income taxes).

TYPE OR PRINT

Name of taxpayer or purchaser of stamps Huntington Beach Company, a corporation

Street address 225 Bush Street,

City, postal zone number, and State San Francisco 4, California

1. District in which return (if any) was filed First District of California
2. Period (if for tax reported on annual basis, prepare separate form for each taxable year) from 1/1, 1948, to 12/31, 1948
3. Kind of tax corporation income tax
4. Amount of assessment, $; dates of payment See statement attached
5. Date stamps were purchased from the Government
6. Amount to be refunded plus statutory interest thereon as provided by law $135,664.29
7. Amount to be abated (not applicable to income, estate, or gift taxes) $

The claimant believes that this claim should be allowed for the following reasons:

See statement attached.

5. Date stamps were purchased from the Government
6. Amount to be refunded plus statutory interest thereon as provided by law $135,664.29
7. Amount to be abated (not applicable to income, estate, or gift taxes) $

The claimant believes that this claim should be allowed for the following reasons:

See statement attached.

(Attach letter-size sheets if space is not sufficient)

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed HUNTINGTON BEACH COMPANY, By R. Bryant - Pres.

Dated 1-3-, 1955

(SEE INSTRUCTIONS ON OTHER SIDE)

16—15504-7

CERTIFICATE

I certify that an examination of the records of this office shows the following facts as to the assessment and payment of the tax: (Show, in the ninth column, by symbols "Pd.," "Ab.," or "Cr.," the nature of each entry in the eighth column.)

Class of tax and taxable year or period	ASSESSMENT LIST			ACCOUNT NO. OR		Amount assessed	PAID, ABATED, OR CREDITED		Pd. Ab. Cr.
	List	Month	Year	Page	Line		Date	Amount	
						$		$	
					Total,	$		Total,	$

I certify that the records of this office show the following facts as to the purchase of stamps:

TO WHOM SOLD OR ISSUED	Kind	Number	Denomination	Date of sale or issue	Amount	If special tax stamp, state:	
						Serial number	Period commencing—
					$		

_____, _____
Director of Internal Revenue. (District)

Claim examined by—

Total, $ Total, $

I certify that the records of this office show the following facts as to the purchase of stamps:

TO WHOM SOLD OR ISSUED	Kind	Number	Denomination	Date of sale or issue	Amount	If special tax stamp, state:	
						Serial number	Period commencing—
					$		

_____, _____
Director of Internal Revenue. (District)

Claim examined by—

_____

Claim approved by—

_____

Chief of Division.

Amount claimed... $_____

Amount allowed... $_____

Amount rejected... $_____

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, both husband and wife must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

U. S. GOVERNMENT PRINTING OFFICE 16—15504-1

GIR

13 Taxpayer keeps its books on the accrual basis of accounting and filed its Federal income tax return for the year ending December 31, 1948, upon the accrual basis. On May 31, 1949, taxpayer duly filed its Federal income tax return for the taxable year ending December 31, 1948, with the Collector of Internal Revenue for the First District of California at San Francisco, California.

Taxpayer's Federal income tax return reported an income tax liability in the amount of $724,802.72. Taxpayer duly paid its Federal income tax liability for the said taxable year on the dates and in the amounts hereinafter indicated:

Date	Amount
March 11, 1949	$182,500.00
May 31, 1949	179,901.36
September 15, 1949	181,200.68
December 14, 1949	181,200.68

On December 13, 1950, in connection with his audit of taxpayer's return for the taxable year 1948, the Internal Revenue Agent in Charge, San Francisco, California, on account of adjustments to income not here material, proposed additional tax for said taxable year in the amount of $457.54. On February 21, 1951, taxpayer paid this amount of additional tax to the Collector of Internal Revenue, First District of California, San Francisco, California, together with interest thereon as provided by law.

In connection with its said Federal income tax return, taxpayer claimed percentage depletion on certain payments it received during the taxable year from Southwest Exploration Company, a cor-
14 poration, hereinafter referred to as "Southwest." These payments were received by taxpayer in accordance with its agreement with Southwest to participate in the net profit from production of petroleum and other hydrocarbons recovered from certain tide or submerged lands in respect of which Southwest had obtained from the State of California State Easement No. 392 for the purpose of extracting petroleum and other hydrocarbons from the submerged areas covered by the said easement. Taxpayer was a party to said easement by reason of its consent to the use of its uplands adjacent to the tidelands covered by the State Easement in the production therefrom by Southwest.

In the above-mentioned agreement between taxpayer and Southwest net profits were defined as "gross profits" from Southwest's operations on a designated portion of State Easement No. 392, minus "chargeable expenses." The gross proceeds included the sale value of all oil produced and saved, all gas produced and sold, and 50 per cent of all gasoline extracted from gas, minus State reserves, plus proceeds of rental, etc., the cost of which had been a charge-

able expense. The chargeable expenses embraced all normal operating costs. State Easement No. 392 did not give to Southwest the right to enter upon the land covered therein and drill for oil and gas. It granted to Southwest the right to produce oil and gas and other hydrocarbons from the lands covered by said easement, provided the wells were slant drilled from upland or littoral drill sites.

During the taxable year here involved taxpayer received total payments of $1,298,222.85 from Southwest on account of its share of the net profit from production from the State-owned tidelands operated by Southwest and claimed percentage depletion thereon in the amount of $357,011.28. In connection with his audit of taxpayer's 1948 corporate income tax return, the Commissioner of Internal Revenue disallowed the deduction for percentage depletion claimed by taxpayer as aforesaid and proposed an additional income tax liability in the amount of $135,664.29. On December 30, 1954, taxpayer paid to the Director of Internal Revenue, San Francisco, California, the said amount of $135,664.29, together with interest thereon in the amount of $47,138.69. Taxpayer hereby claims refund of said amounts plus statutory interest thereon.

Based upon the pertinent facts, taxpayer submits that it possessed a capital investment in the oil-producing property by reason of the dedication of its property to the production of oil and gas from the area covered by State Easement No. 392. Taxpayer also owned a right to share in the net profits of production from the State Easement. Taxpayer's possibility of profit from the use of its property and rights in respect of production from the State Easement was restricted to and solely dependent upon the extraction of oil and gas from the State Easement. As a result of the foregoing, taxpayer possessed an economic interest in the oil and gas in place and is entitled to depletion on the payments it received from Southwest during the taxable year here involved.

16 EXHIBIT B TO PETITION

C:A:C1-Form No. 50

U. S. Treasury Department
District Director of Internal Revenue
San Francisco 2, California

Refer to:

C:A:C1-CMB/mg January 4, 1955.
Room 723
Huntington Beach Company
225 Bush Street
San Francisco, California
Re: Claim for Refund of Income Tax in the amount of $135,664.29.

For the Period December 31, 1948

Gentlemen:

In accordance with the provisions of Section 3772(a)(2) of the Internal Revenue Code, this notice of disallowance in full of your claim or claims is hereby given by registered mail.

By direction of the Regional Commissioner.

Very truly yours,
GLENN T. JAMISON,
District Director of Internal Revenue.

17 In the United States Court of Claims

[Title omitted]

ANSWER—Filed April 1, 1955

The defendant in the above-styled action by its Assistant Attorney General answers plaintiff's petition as follows:

A. Denies every allegation not admitted, qualified or otherwise specifically referred to below.

B. Further answering the petition:

1. Admits the allegations in paragraphs 1, 2, and 3, except to deny the allegation in paragraph 3(b) that the payments received from the Southwest Exploration Company represented plaintiff's share of the net profits during the taxable year of oil and gas production from tidelands operated by Southwest.

2. Admits the allegations of paragraphs 4(a) and (b) and denies the allegations of paragraphs 4(c) and (d).

18 3. Admits the allegations of paragraph 5(a).

4. Denies the allegations of paragraph 5(b).

5. Admits the allegations of paragraph 5(e), except that all allegations of fact in the claim for refund are denied.

6. Admits the allegations of paragraphs 6(a) and (b).

7. Denies the allegations of paragraph 6(c).

8. Denies the allegations of paragraph 7.

9. Denies the allegations of paragraphs 8(a), (b), (c), and (d).

10. Has no knowledge nor information as to the truth of the allegations in paragraphs 8(e), (f), and (g), except to deny that any part of the tax or interest collected by the defendant, from the plaintiff, as alleged in paragraph 8(f), "remains due and owing from defendant to plaintiff."

WHEREFORE, defendant demands judgment that plaintiff's petition be dismissed, together with the costs of this action.

H. BRIAN HOLLAND,
Assistant Attorney General.

HILBERT P. ZARKY,
KENNETH E. LEVIN,
Attorneys.

19 [File endorsement omitted]

In the United States Court of Claims

[Title omitted]

AGREED STATEMENT OF FACTS—Filed April 26, 1955

Come now the above parties by their attorneys of record and agree that the following stated facts are true:

1. Plaintiff is a corporation duly organized and existing under the laws of the State of California. Its principal office is located at San Francisco, California.

2. On or about May 31, 1949, plaintiff duly filed with the Collector of Internal Revenue, First District of California (subsequently designated as District Director of Internal Revenue, San Francisco, California, and herein sometimes referred to as "Collector"), its corporate income tax return for the taxable year ended December 31, 1948, prepared in accordance with the accrual method of accounting. Attached hereto and marked "Exhibit 1" is a true copy of plaintiff's corporate income tax return for the taxable year ended December 31, 1948.

3. Plaintiff's corporate income tax return for the taxable year ended December 31, 1948, disclosed ordinary net income in the amount of $1,908,703.91. In arriving at said amount of ordinary net income for normal tax and surtax purposes plaintiff deducted

percentage depletion of $357,011.28 on account of payments
20 of $1,298,222.85 received from Southwest Exploration Company, a corporation (hereinafter designated as "Southwest"). These payments of $1,298,222.85 were made by Southwest in accordance with and were determined under the provisions of Exhibit 11 hereof.

4. In its corporate income tax return for the taxable year ended December 31, 1948, plaintiff computed and disclosed its corporate income tax liability for such year in the total amount of $724,802.72. The amount of its Federal income tax liability as disclosed by its return was duly paid to the Collector and is not in controversy herein.

5. On December 13, 1950, the Internal Revenue Agent in Charge at San Francisco, California, acting on behalf of the Commissioner of Internal Revenue, proposed an additional income tax liability for the taxable year 1948 in the amount of $457.54. All of said amount of $457.54, together with interest thereon, was duly paid by plaintiff to the Collector on February 21, 1951, and is not in controversy herein.

6. Upon subsequent audit and review of plaintiff's income tax return for the taxable year 1948, the District Director of Internal Revenue, San Francisco, California (formerly the Collector of Internal Revenue and hereinafter referred to as "District Director"), proposed additional income tax for the taxable year 1948 in the amount or $135,664.29. On December 30, 1954, plaintiff duly paid to the District Director all of said amount of additional tax of
21 $135,664.29, together with statutory interest thereon of $47,138.69.

7. The additional income tax of $135,664.29 for the year 1948, as determined by defendant and referred to in the preceding paragraph, was based upon the disallowance of percentage depletion of $357,011.28 as claimed by plaintiff on the payments received by it from Southwest during the taxable year 1948 in the amount of $1,298,222.85 referred to in paragraph 3 above.

8. On January 3, 1955, plaintiff timely filed with the District Director a verified claim for refund of income tax for the taxable year ended December 31, 1948, in the amount of $135,664.29, plus interest thereon of $47,138.69, together with interest on said amounts as allowed by law. Attached hereto and made a part hereof is a true copy of said claim marked "Exhibit 2."

9. In accordance with the applicable provisions of the Internal Revenue laws, the Commissioner of Internal Revenue notified plaintiff of the disallowance of its aforesaid claim by registered letter dated January 4, 1955. Attached hereto and made a part hereof is a copy of said notice of disallowance marked "Exhibit 3."

10. In 1938 the State of California passed the State Lands Act of 1938, now part of the Public Resources Code dealing with the ex-

ploitation of oil deposits from the State tidelands. From August 8, 1938, to August 13, 1938, the State Lands Commission published a notice entitled "Notice of intention of state lands commission to receive offers to enter into an agreement or agreements for extraction of oil and gas and other hydrocarbons from certain tide and submerged lands of the state situate in Orange County, California" (hereinafter referred to as the "Notice"). Attached hereto
22 and marked "Exhibit 4" is a true copy of the above Notice setting forth the terms and conditions under which bids would be received by the Commission.

11. The legal descriptions set forth in the original Notice are omitted fromExhibit 4 for the sake of brevity. The legal description was divided into five parcels, designated "A," "B," "C," "D," and "E." Each parcel was said to contain 167 acres, more or less. It is stipulated by the parties hereto that the area of tidelands and submerged lands identified in the original Notice as parcels A to E, inclusive, of said Orange County, California, tidelands and submerged lands constituted the entire area covered by State Easement No. 392 which Southwest subsequently obtained from the State of California in the manner hereinafter set forth.

12. Southwest Exploration Company, a corporation ("Southwest"), is a corporation organized under the laws of California and was incorporated on June 20, 1933, but remained completely inactive until 1938. Its principal office is located at Los Angeles, California. Prior to the agreements dated August 25, 1938 (Exhibits 5 and 6 hereof), Southwest did not own, lease, operate or control any of the uplands or littoral lands adjacent to the area referred to in the Notice and subsequently identified as "States Easement No. 392."

13. Prior to the transmittal of its bid for State Easement, subsequently identified as "State Easement No. 392," Southwest, as "Permittee," entered into an agreement for a permit dated
23 August 25, 1938, with Huntington Beach Company, a corporation, plaintiff herein, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, Bolsa Land Company, a corporation, Bolsa Chica Gun Club, a corporation, and Standard Oil Company of California, a corporation, as "Permittors." Attached hereto and marked "Exhibit 5" is a true and correct copy of the above-described agreement. It is stipulated by the parties that the lands of the "Permittors" referred to as "uplands" in the Notice (Exhibit 4 hereof) and in the agreement, identified as "Exhibit 5" hereof, and more particularly described in the first "whereas" paragraph appearing on page 1 of said Exhibit 5, constituted all of those lands referred to as littoral lands and uplands in section 1 of Agreement for Easement No. 392 and elsewhere therein, which are more particularly described in section 1 thereof.

A true copy of said Agreement for Easement constitutes Exhibit 8 of this stipulation.

14. On August 25, 1938, Southwest also entered into a second agreement with plaintiff and other upland owners setting forth in detail the procedures to be followed by Southwest in conducting operations from the uplands. Attached hereto and marked "Exhibit 6" is a correct copy of said agreement. The agreement refers in its text to Exhibit 1 which is identified as "Exhibit 5" of this stipulation. Southwest was the only bidder for State Easement No. 392.

15. In accordance with the terms and conditions of the
24 Notice, Southwest submitted its bid to the State Lands Commission on August 30, 1938. Attached hereto and marked "Exhibit 7" is a correct copy of the letter transmitting Southwest's bid for easement. It is stipulated that with said transmittal letter Southwest filed with the State Lands Commission, the following documents:

(a) Form of Agreement for State Easement, later identified as "No. 392" with date omitted but signed by Southwest through its president and secretary; attached to the said Agreement for State Easement No. 392 were those portions of Exhibit 8 appearing at the end thereof entitled "Endorsement by Upland Owners," "Exhibit A (for entire tract)" and "Exhibit B";

(b) Permit agreement identified as Exhibit 5 of this stipulation;

(c) Cashier's check for $15,000 payable to the Treasurer of the State of California;

(d) Certified copy of resolutions authorizing Southwest's officers to execute Exhibit 5 and Exhibit 8 hereof;

(e) Certificate of ownership showing that all of Southwest's stockholders were residents of the State of California.

It is further stipulated that Southwest's bid conformed in all respects to the requirements of the State Lands Commission. Southwest furnished the $25,000 bond required by the Agreement for State Easement No. 392.

16. In accordance with the terms and provisions of the
25 State Lands Act of 1938 (Cal. Stats. Ex. Sess. 1938, c. 5) Southwest's bid was accepted, and it entered into an Agreement for State Easement No. 392 with the State Lands Commission on September 26, 1938. Attached hereto and marked "Exhibit 8" is a correct copy of said Agreement for State Easement No. 392.

17. Attached hereto and marked "Exhibit 9" and "Exhibit 10," respectively, are maps showing the location of Southwest's wells in the area covered by State Easement No. 392 with respect to the Main Zone and to the Jones Zone, respectively. It is stipulated that said maps are correct in so far as they attempt to show the location

of the tops and bottoms of Southwest's wells, the location of Standard Oil Company of California's vertical upland wells, the numbers assigned to Southwest's wells and Standard Oil Company of California's wells as of December 31, 1945, and the names of the owners and lessees of the uplands. There were no "filled lands" as that term is used in Article 6 of the State Lands Act of 1938 (Cal.Stats.Ex.Sess. 1938, c. 5) which were situated adjacent or contiguous to or otherwise usable or available in the extraction and exploitation of oil, gas or other hydrocarbon substances from the area constituting State Easement No. 392.

18. Exhibit 11 of this stipulation is a correct copy of an agreement dated September 27, 1938, between Southwest, as party of the first part, and Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, and Pacific Electric Land Company, a corporation, as second parties. The agreement of
26 September 27, 1938, supplements the prior agreements of August 25, 1938, between Southwest and the upland owners and provides a manner of computation of the amounts payable to plaintiff and other upland owners in consideration of the rights and privileges given by the upland owners to Southwest in the two agreements entered into on August 25, 1938, which constitute Exhibit 5 and Exhibit 6 hereof. Southwest entered into the agreement of September 27, 1938 (Exhibit 11), with plaintiff and other upland owners in consideration of the rights and privileges granted to Southwest by the upland owners in the agreements of August 25, 1938 (Exhibit 5 and Exhibit 6).

19. Attached hereto and marked "Exhibit 12" and "Exhibit 13" of this stipulation are amendments to the Agreement for State Easement No. 392 duly executed on December 6, 1938, and March 22, 1939, respectively.

20. Southwest also developed the Jones Zone, all of the wells in that zone being marked "J-1," "J-2," etc., in Exhibit 10 hereof. All surface facilities and operations in connection with and for the drilling of and production of oil and gas from the wells covered by State Easement No. 392 and the tops of all such wells drilled pursuant thereto and in accordance with the terms of Southwest's agreements with the upland owners (Exhibit 5, Exhibit 6 and Exhibit 11, respectively, of this stipulation) during the period here material from which plaintiff received payments from Southwest, computed in accordance with the agreement of the parties dated September 27, 1938 (Exhibit 11 hereof), were on upland property owned by Huntington Beach Company, plaintiff herein. Said wells were drilled on a slant toward the ocean and, accordingly,
27 went through and under land owned by the plaintiff herein and land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company so that the bottoms of

said wells were out under the Pacific Ocean. Attached hereto and marked "Exhibit 14" is a diagrammatic chart illustrative of the method of slant drilling of wells from the surface of the uplands employed by Southwest in the production of oil and gas from the area covered by State Easement No. 392.

21. Southwest erected on the lands owned by plaintiff all the ordinary facilities, including its field office, settling and shipping tanks, pipe lines, and other equipment and appliances required in connection with its business operations. Under the provisions of State Easement No. 392 it was required that each well be drilled by slant drilling from the uplands to and into the subsurface of the State lands covered by State Easement No. 392. All subsurface operations in connection with the drilling and operation of the wells covered by State Easement No. 392 on account of which plaintiff received payments from Southwest were conducted from and through the land owned by plaintiff herein, and through land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company.

22. Huntington Beach Company, plaintiff herein, and other upland owners, in accordance with the agreements dated August 25, 1938, and the agreement dated September 27, 1938 (Exhibit 5, Exhibit 6 and Exhibit 11, respectively, hereof) received payments during the taxable year which were referred to in the September 27, 1938, agreement (Exhibit 11) as "an amount equal to the following percentages of the 'net profits'" from the operation of the wells here involved as shown below:

Huntington Beach Company	17.75 per cent
Pacific Electric Railway Company	1.576 per cent
Pacific Electric Land Company	5.174 per cent
	24.5 per cent

23. Attached hereto and marked "Exhibit 15" is a schedule reflecting the amounts of the payments made to plaintiff by Southwest during the taxable years 1942 to 1948, inclusive, determined in accordance with the terms of the agreement of September 27, 1938 (Exhibit 11). Such schedule was prepared by J. H. Singer, Supervisor, General Accounting Section, Huntington Beach Company, from reports submitted to said company by Southwest with respect to production from State Easement No. 392 for the above-mentioned period and, if called as a witness, he would so testify.

Dated: April 25, 1955.

SIGVALD NIELSON
Attorney for Plaintiff
H. BRIAN HOLLAND
Attorney for Defendant

29 EXHIBIT 4

Notice of intention of State Lands Commission to receive offers to enter into an agreement or agreements for extraction of oil and gas and other hydrocarbons from certain tide and submerged lands of the State, situate in Orange County, California.

Notice is hereby given by the State Lands Commission, acting pursuant to "State Lands Act of 1938" (Chapter 5, Statutes of California. Extra Session 1938) of intention to enter into an agreement or agreements for the purpose of extraction of oil and gas and other hydrocarbons from those certain parcels of tidelands and submerged lands situate in the County of Orange, State of California, more particularly described as follows, to-wit:

PARCEL "A"
PARCEL "B"
PARCEL "C"
PARCEL "D"
PARCEL "E"

Each bidder may propose to enter into an agreement with the State of California for the extraction of oil, gas and other hydrocarbons from the hereinbefore described Parcels indentified as "A," "B," "C," "D," and "E," as one tract, or from one or more of said parcels.

Each bidder, as a condition precedent to the consideration of such bidder's bid, in addition to other qualifications contained in "State Lands Act of 1938," shall present at the time of delivery of such bid or bids to the State Lands Commission evidence satisfactory to the Commission of the present ability of such bidder to furnish all necessary sites and rights-of-way without cost or obligation to the State for all operations contemplated under the provisions of form of bid, and any bid not accompanied by such evidence will be rejected by the Commission.

Evidence of the present ability of a bidder to furnish all necessary sites and rights of way for the operations contemplated under the provisions of the form of agreement for easement shall include the following:

(1) The owner or owners of real property described as the "uplands" in said agreement shall execute the endorsement on said agreement acknowledging that the bidder has been granted all such necessary sites, rights of way and easements; and

(2) The bidder shall transmit to the commission with his bid, either (a) the instrument or instruments, or certified copies thereof, vesting in such bidder such sites, rights of way and easements,
30 or (b) certified copies of such instrument or instruments together with the affidavits of the owners of said uplands that

the original copies of such documents have been placed in escrow to be delivered to the bidder in the event the bid is accepted.

The finding of the commission as to whether or not a bidder has the present ability to furnish all necessary sites and rights of way for all operations contemplated under the agreement for easement for which the bid is submitted shall be final and conclusive.

Each bid submitted pursuant to this notice shall be accompanied by a certified or cashier's check of a responsible bank in California payable to the Treasurer of the State of California in the sum of $15,000 as a deposit of evidence of good faith, and except in the case of the successful bidder will be returned to the respective bidder. Should the successful bidder fail or refuse to execute the agreement for easement within fifteen days of the award thereof by the commission, the deposit shall be forfeited to the State of California, otherwise the amount of said deposit shall be applied upon the annual rental rate for the first year and the balance, if any, refunded to the Grantee.

All bids made pursuant to this notice shall be addressed to the State Lands Commission, sealed and delivered to State Lands Commission, Room 301, California State Building, Los Angeles, on or before 12 m., of the 1st day of September, 1938. Upon the sealed envelope containing such bid shall be written "Bid of (name of bidder) made pursuant to notice of intention of State Lands Commission to enter into agreement for extraction of oil, gas and other hydrocarbons from the tide and submerged lands of the State of California, in the County of Orange, State of California."

Bids received pursuant to this notice will be publicly opened at 2 p. m., September 1, 1938 at Room 301, State Building, Los Angeles, California, or at such later time and date as the Commission shall determine.

Form of bid entitled, "Agreement for Easement No. ————, Huntington Beach," for each of said parcels or for the tract as a whole may be obtained at the office of the Commission in Room 301, California State Building, Los Angeles, California.

The Commission reserves the right to reject any and all bids received pursuant to this notice.

State Lands Commission
By WEEB SHADLE
Executive Officer.

Pub. Aug. 8, 9, 10, 11, 12, 13, 1938.

31 EXHIBIT 5

This Permit, dated the *25th* day of *August*, 1938, by and between *Huntington Beach Corp.*, a corporation, *Pacific Electric Railway Company*, a corporation, *Pacific Electric Land Company*, a corporation, *Bolsa Land Company*, a corporation, *Bolsa Chica Gun Club*, a corporation, and *Standard Oil Company of California*, a corporation, parties of the first part, herein collectively referred to as "Permittors", and *Southwest Exploration Company*, a corporation, party of the second part, herein referred to as "Permittee",

Witnesseth:

Whereas, Permittee has applied to Permittors for the necessary easements, rights and right of ways over, on, and through those certain lands situate in the County of Orange, State of California, hereinafter referred to as "uplands", and more particularly described as follows:

> Commencing at a point at the intersection of the ordinary high water mark of the Pacific Ocean with the Southwesterly prolongation of the Northwesterly line of Twenty-third Street in the City of Huntington Beach, thence Northeasterly along said Southwesterly prolongation of the Northwesterly line of Twenty-third Street and along the Northwesterly line of said Twenty-third Street to a point at the intersection of the Northwesterly line of said Twenty-third Street with the Northwesterly prolongation of the Northeasterly line of Palm Avenue, thence Northwesterly along said Northwesterly prolongation of the Northeasterly line of said Palm Avenue to a point in the Northerly boundary line of the City of Huntington Beach, thence westerly along the said Northerly boundary of the City of Huntington Beach to the quarter section line running North and South through Section Four (4), Township Six (6) South, Range Eleven (11) West, thence S. 40° 36' W. to the ordinary high water mark of the Pacific Ocean, thence Southeasterly along said ordinary high water mark of the Pacific Ocean to the point of beginning, subject to easements, right of ways and other matters of record;

for the conduct of Permittee's operations under that certain Agreement for Easement No. ———, hereinafter referred to as "State Easement", a copy of which is hereto annexed, marked "Exhibit A", and by this reference made a part hereof, for the extraction of oil, gas and other hydrocarbon substances from the lands described

in said State Easement comprising approximately 835 acres and therein and hereinafter referred to as "State lands";

Now, Therefore, in consideration of the sum of Ten Dollars ($10.00) and other good and valuable considerations, paid by
32 Permittee to Permittors, the receipt of which is hereby acknowledged, Permittors do hereby give unto Permittee, its successors and assigns, the easements, rights and right of ways hereinafter specifically set forth, over, on and through said uplands, upon the following terms and conditions:

1. Permittee shall have the right to construct, use, maintain, erect, repair, and replace upon said uplands, and to remove therefrom, all pipe lines, telephone and telegraph lines, derricks, tanks, machinery, buildings, and other surface or subsurface structures reasonably necessary to Permittee for the purpose of drilling for, producing, extracting, taking and removing oil, gas and other hydrocarbons from said State lands; and for the purpose of storing, transporting, and dehydrating oil, gas and other hydrocarbons produced from said State lands, or reasonably necessary to Permittee for the performance upon the part of the Permittee of the covenants, conditions and agreements set forth and contained in said State Easement, together with the right of ingress and egress for any of the purposes herein referred to.

2. The easements, rights and right of ways herein given shall be so used and exercised by Permittee so as to interfere as little as possible with the use and occupation by said Huntington Beach Company and said Bolsa Land Company and said Pacific Electric Land Company and said Bolsa Chica Gun Club of their respective portions of said uplands for agricultural, horticultural, grazing or other uses. Permittee covenants and agrees that whenever and wherever drilling operations hereunder shall necessitate passage under any road, railroad track or other surface structure, that such drilling operations shall be conducted and maintained at a sufficient depth below such road, railroad track or other surface structure as not to destroy, damage, or interfere with the use of the same. No derricks, machinery, or surface structures or other equipment or appliances of any nature shall be located by Permittee, nor shall any surface operations of any nature whatsoever be conducted by Permittee upon that portion of said uplands which is comprised of the sixty-foot right of way of Pacific Electric Railway Company, without the consent of Pacific Electric Railway Company.

3. All wells drilled by Permittee hereunder shall originate
33 on said uplands and shall be slanted or deflected through said uplands into said State lands and shall be so bottomed and completed that all of the perforated ———— producing intervals thereof shall be located within the confines of said State

lands and nothing herein contained shall be so construed as to permit Permittee to bottom or complete any well or to locate or maintain the perforated pipe or producing interval thereof within, or to produce oil, gas, or other hydrocarbons from or under, said uplands or any of the lands of Permittors.

4. Each of the Permittors does, for itself, its successors and assigns, give to the Permittee, its successors and assigns, the easements, rights and right of way hereinbefore set forth, fully and completely to the extent that such Permittor has the right, title, interest or ability so to do, and jointly and severally with its co-Permittors; but without ———— on its part as to the extent of such right, title, interest or ability.

5. That Permittee shall protect, indemnify and hold Permittors and each of them, harmless from and against any and all claims for loss, damage, or injury to others (including costs and reasonable attorneys' fees in the event suit is brought) and shall pay any loss, damage or expense which Permittors may suffer or incur, arising out of or in any way connected with the existence or operation of any wells drilled by Permittee pursuant to said State Easement and from any operation or activity of Permittee on or in or in connection with any of said wells and from or on account of any contact, collision or other interference by any well drilled by Permittee pursuant to said State Easement with any other well in, on or which crosses said uplands, and from or on account of any contact, collision or other interference by any such other well with any well drilled by Permittee pursuant to the provisions of said State Easement. Permittee shall assume all risk and shall be accountable for anything occurring on account of or due to the existence or operation of said well and shall protect, indemnify and hold Permittors, and each of them, harmless therefrom and against any injury,
34 loss or damage arising out of or due to the enjoyment of the rights hereby granted to Permittee or due to the existence or operation of any wells drilled by Permittee pursuant to said State Easement; Permittee further agrees to protect, indemnify and hold harmless Permittors, and each of them, and the lands of Permittors, and of each of them, from any and all mechanics and other liens and any and all cost or expense incurred on account thereof arising out of, asserted, or in any manner due to anything done or caused to be done in connection with any well drilled by Permittee hereunder and pursuant to the provisions of said State Easement.

6. The easements, rights and right of ways herein given to Permittee shall continue and exist during such time as said State Easement, or any modification, renewal, extension of, or substitute therefor shall be in force and effect.

In Witness Whereof, the Permittors and Permittee have caused

this instrument to be executed in their respective corporate names by their respective authorized officers whose names are hereunto subscribed.

Huntington Beach Company
By M. E. LOMBARDI (seal)
Vice President
By G. M. FOSTER
Assistant Secretary

Pacific Electric Railway Company
(seal) By O. A. SMITH.
President
By L. A. LOVELL
Secretary

Pacific Electric Land Company
(seal) By O. A. SMITH.
President
By L. A. LOVELL
Secretary
(seal)

Bolsa Land Company
By H. W. KELLER
President
By ROBERT N. FRICK
Secretary

Bolsa Chica Gun Club
By E. O. McLAUGHLIN
V.-Pres.
By JAMES PAGE
Secy. (seal)

35 Standard Oil Company of California
By R. K. DAVIES
Vice President (seal)
By LEE LAIRD
Assistant Secretary
PERMITTORS.

Southwest Exploration Company
By ——— ———
President
By ——— ———
Secretary
PERMITTEE.

36 EXHIBIT 6

This Agreement, dated the 25 day of August, 1938, by and between *Huntington Beach Company*, a corporation, *Pacific Electric Railway Company*, a corporation, *Pacific Electric Land Company*, a corporation, and *Standard Oil Company of California*, a corporation, parties of the first part, herein collectively referred to as "Permittors", and Southwest Exploration Company, a corporation, party of the second part, herein referred to as "Permittee",

Witnesseth:

WHEREAS, by a certain agreement between the parties hereto, dated the 25th day of August, 1938, a copy of which is hereto attached, marked "Exhibit 1", and by this reference made a part hereof, Permittors gave to Permittee, its successors and assigns, upon the terms and conditions therein provided, certain easements, rights and rights-of-way therein specifically set forth, over, on and through certain lands situate in the County of Orange, State of California, described in said agreement marked "Exhibit 1" and therein and hereinafter referred to as "uplands", for the conduct of Permittee's operations under that certain Agreement for Easement No.————, therein and hereinafter referred to as "State Easement", a copy of which is attached to "Exhibit 1" and marked in "Exhibit 1" as "Exhibit A" and by this reference made a part hereof, for the extraction of oil, gas and other hydrocarbon substances from the lands described in said State Easement comprising approximately eight hundred thirty-five (835) acres and therein and hereinafter referred to as "State lands"; and

Whereas, the parties hereto desire that certain terms, conditions, limitations, reservations, and restrictions, in addition to the terms and conditions set forth in said agreement marked "Exhibit 1", shall apply to the exercise by Permittee of the easement, rights and rights of way thereby given to Permittee:

37 NOW, THEREFORE, in consideration of the premises and of the mutual covenants and agreements hereinafter set forth, the parties hereto do hereby agree as follows:

1. The surface location and the subsurface course through said uplands, of each well to be drilled by Permittee through said uplands pursuant to said State Easement shall be mutually agreed upon by said Standard Oil Company of California, hereinafter referred to as "Standard", and Permittee, and Standard's written approval thereof shall be obtained, prior to the commencement of Permittee's operations upon such well.

2. Permittee, in the drilling of each well through said uplands pursuant to said State Easement, shall adhere and conform to the

subsurface course and location through said uplands mutually agreed upon as hereinabove provided, and no drilling, redrilling, deepening, or other work which would change the subsurface course or location of said well through said uplands shall be undertaken by Permittee until such change shall have been mutually agreed upon with Standard and until Standard's written approval thereof shall have been obtained.

3. The surface location for all pipe lines, telephone and telegraph lines, derricks, tanks, machinery, buildings, and other structures and surface facilities to be erected by Permittee upon said uplands (exclusive, however, of that portion of said uplands which is comprised of Ocean Avenue and of that portion of said uplands which is comprised of the sixty-foot operating strip of Pacific Electric Railway Company lying immediately adjacent to the southwesterly line of Ocean Avenue and which is referred to in Paragraph 2 of said agreement marked "Exhibit 1"), shall be mutually agreed upon by Standard and Permittee, and Standard's written approval of such surface locations shall be obtained prior to
38. the installation of any such lines, structures or facilities.

4. In the drilling and construction of all wells drilled by Permittee through said uplands pursuant to said State Easement, Permittee shall use and install therein materials and equipment of good quality and condition and all of said wells shall be drilled by Permittee in the best workmanlike manner in accordance with good oil field practice; and all water sands encountered therein shall be effectively and in a proper manner plugged off. All drilling and other operations of Permittee hereunder and pursuant to the provisions of said State Easement shall at all times be conducted by Permittee in a good and workmanlike manner and so as to prevent and avoid danger of injury or damage therefrom to the wells and property of Permittors and each of them.

5. Permittee shall, upon the written request of Standard or Pacific Electric Railway Company or both, furnish copies of logs, records or well cores, electrical logs or surveys, and water entrance surveys, plats and surveys showing locations and courses with respect to each and every well drilled by Permittee through said uplands pursuant to said State Easement, together with complete information as to the location, course, mechanical condition, pressures, water shutoffs, oil, gas and water production, perforations, condition, fluid levels, depth pressures, size of pump, length and speed of stroke, and other facts relative thereto, to either or both parties requesting the same. If the data and information so furnished by Permittee are incorrect or for any reason insufficient to establish the location, course, or condition of any of said wells, Permittee will, upon being notified of that fact, promptly furnish such additional information as may be required by Standard, or Pacific Electric Railway Com-

pany, and if Permittee fails to furnish the data and information so required, Standard or Pacific Electric Railway Company shall have the right to make such examination as may be necessary to obtain the desired information. Standard or Pacific Electric Railway Company, at all reasonable times, shall be entitled to inspect
39 all operations of the Permittee upon said uplands and under said State Easement, and shall have the right of access to any well drilled by Permittee through said uplands pursuant to the provision of said State Easement and to all records and survey data pertaining thereto as to the history, location, course, mechanical condition, equipment, pressures, water shut-offs, oil production, perforations and condition of said well.

6. That if, as and when any of Permittee's wells are abandoned, Permittee shall promptly abandon the same in accordance with regulations of the State of California, Department of Natural Resources, Division of Oil and Gas, and in addition thereto, shall promptly and effectively plug with cement in a good and workmanlike manner such portion or portions thereof and take such reasonable precautions and protective measures with reference thereto, as may, in the judgment of Standard, be necessary to prevent injury or damage to, or interference with, the property or wells of Standard.

7. Permittee shall comply with all laws of the State of California and all rules and regulations of any agency of the State of California having jurisdiction therein, and all laws of the United States of America and all rules and regulations of any agency of the United States of America having jurisdiction therein, relating to the drilling, maintenance and operation of oil and gas wells drilled through said uplands pursuant to said State Easement and the production of oil and gas therefrom.

8. Subject to the provisions of said State Easement with respect thereto, Permittee shall comply with any reasonable conservation or curtailment program or programs which may at any time and from time to time affect the production of oil and gas from wells to be drilled by Permittee through said uplands pursuant to said State Easement, which program or programs are mutually agreed to by the producers of a majority of the total production of oil and gas from each zone or separate underground source of supply
40 in which Permittee is authorized to bottom its wells pursuant to said State Easement. Permittee shall conduct all producing operations in wells drilled through said uplands pursuant to said State Easement in accordance with good oil field engineering practice.

9. The rights hereby granted are personal to the Permittee and shall not be assigned in whole or in part without the written consent of Permittors. Subject to all of the terms and conditions hereof,

this agreement shall be binding upon the successors and assigns of the parties hereto.

10. Any and all reasonable costs or expense incurred by Permittors in enforcing or effectuating this agreement will be reimbursed by Permittee on demand.

11. Permittors expressly reserve unto themselves, their present and future subsidiaries, and to their successors and assigns, the right to give easements or subsurface well crossings in, upon and under said uplands, together with right of ways through, over, under, upon and across said uplands for roads, power lines, telephone and telegraph lines, pipe lines and other instrumentalities, whether similar to those herein expressly enumerated or not; provided, however, that Permittors shall not give such easements or subsurface well crossings in, upon and under said uplands for the purpose of drilling wells into any portion of the lands described in said State Easement lying below the ordinary high water mark, in which and so long as, Permittee shall retain the interest therein granted it by said State Easement.

12. Permittee shall in all respects exercise the surface privileges hereby granted in such manner as to interfere as little as practicable with operations of Permittors, and each of them. No building, rig or other structure owned by Permittors shall be removed or relocated by Permittee without the written consent of the particular Permittor owning same.

41 13. The rights herein given Permittee are subject to all existing agreements and leases between Standard and any of the other Permittors, together with any present and future renewals, extensions or modifications thereof, and are subject also to the reservations set forth in said agreements and leases as so renewed, extended or modfiied. The rights herein given to the Permittee are also subject to all existing subsurface crossing permits heretofore given by Permittors, or any of them, for wells of others through said uplands, and also to all other existing grants, conveyances, leases, agreements, reservations, right of ways, easements, permits, licenses and other privileges affecting said uplands.

14. Any notice, information or data to be given said Huntington Beach Company hereunder shall be valid if mailed by registered maid, postage prepaid, to Huntington Beach Company at 225 Bush Street, San Francisco, California.

Any notice, information or data to be given said Pacific Electric Railway Company hereunder shall be valid if mailed by registered mail, postage prepaid, to Pacific Electric Railway Company, at *Pacific Electric Bldg., Los Angeles, California.*

Any notice, information or data to be given said Pacific Electric Land Company hereunder shall be valid if mailed by registered

mail, postage prepaid, to Pacific Electric Land Company, at *Pacific Electric Bldg., Los Angeles, California.*

Any notice, information or data to be given said Standard Oil Company of California hereunder shall be valid if mailed by registered mail, postage prepaid, to Standard Oil Company of California, at 225 Bush Street, San Francisco, California.

Any notice or other communication to be given by Permittors to Permittee shall be valid if mailed by registered mail, postage prepaid, to Permittee, at Long Beach, California.

42-43 In Witness Whereof, the Permittors and Permittee have caused this insrument to be executed in their respective corporate names by their respective authorized officers whose names are hereunto subscribed.

Huntington Beach Company
Name in copy illegible .....
Vice President
Name in copy illegible .....
Assistant Secretary

Pacific Electric Railway Company
Name in copy illegible .....
Name in copy illegible .....
Secretary

Pacific Electric Land Company
Name in copy illegible .....
Name in copy illegible .....
Secretary

Standard Oil Company of California
Name in copy illegible .....
Vice President
Name in copy illegible .....
Assistant Secretary
Permittors

Southwest Exploration Company
Name in copy illegible .....
President
Name in copy illegible .....
Secretary
Permittee.

44 EXHIBIT 7

Los Angeles, Cal.,
August 30, 1938.

State Lands Commission,
State of California,
State Building,
Los Angeles, California.

Gentlemen:

In pursuance of your call for bids for granting leases or easements at Huntington Beach, California, Southwest Exploration Company hereby submits on your form and as its bid an Agreement for Easement No. —— covering the entire area called for in your bid. The Agreement for Easement has been duly signed by the Southwest Exploration Company, a corporation, and the endorsement by upland owners has been duly signed by Huntington Beach Company, Pacific Electric Railway Company, Pacific Electric Land Company, Bolsa Land Company, Bolsa Chica Gun Club, and Standard Oil Company of California.

We are also enclosing an Agreement between Huntington Beach Company, Pacific Electric Railway Company, Pacific Electric Land Company, Bolsa Land Company, Bolsa Chica Gun Club, and Standard Oil Company of California, therein designated as Permittors, and Southwest Exploration Company, therein designated as Permittee. The agreement, as you will note, grants to Southwest Exploration Company all necessary easements, rights of way and other rights reasonably necessary to this Company for the performance upon the part of this Company of the covenants, conditions and agreements set forth and contained in the State Easement.

We are also enclosing as provided for in the bid Cashier's Check in the sum of $15,000.00; also certified copy of resolution authorizing the officers of Southwest Exploration Company to execute the easement; and certified copy of resolution of Southwest Exploration Company authorizing the officers to execute the Easement Agreement.

Also you will find Certificate of Ownership showing that all stockholders of Southwest Exploration Company are residents of the State of California.

We believe that we have fully fulfilled the terms and conditions called for in Notice for Bids. If there is any other information or documents required, kindly advise.

Very truly yours,
Southwest Exploration Company
By —— ——
President.

45 EXHIBIT 8

(Copy)

STATE LANDS COMMISSION
STATE OF CALIFORNIA

Agreement for Easement No. 392

Huntington Beach

This Agreement Made and entered into this 26th day of September 1938, by and between the State of California, through the State Lands Commission of the State of California, party of the first part, hereinafter called the "State" and

Southwest Exploration Company,
a corporation,

party of the second part, hereinafter called the "Grantee", pursuant to the State Lands Act of 1938, being Chapter 5, Statutes of California, Extra Session, 1938, hereinafter referred to as the "Act" and by this reference made a part hereof.

The parties hereto do hereby agree as follows:

Section 1. That the State, in consideration of the royalty to be paid, the covenants to be performed, and the conditions to be observed by the Grantee, as herein set forth, does hereby grant to the Grantee an exclusive easement appurtenant to the lands of the Grantee hereinafter described, through, in and under lands of the State of California (hereinafter referred to as the State lands), hereinafter more particularly described, together with the exclusive right to drain, take, receive, extract, remove, and produce from the State lands oil, gas, and other hydrocarbon substances through certain oil wells to be drilled, operated and maintained by the Grantee in the manner hereinafter provided, the tops of which such wells shall be located upon that portion of those certain littoral lands and uplands lying within a prolongation or projection northerly of the sidelines of the hereinafter described parcel of state lands (which portion is hereinafter referred to as the uplands), which said littoral lands and uplands are situate in the County of Orange, State of California, and more particularly described as follows, to wit:

Exhibit "A"

46 Commencing at a point at the intersection of the ordinary high water mark of the Pacific Ocean with the Southwesterly prolongation of the Northwesterly line of Twenty-third Street in the City of Huntington Beach, thence Northeasterly along said Southwesterly prolongation of the Northwesterly line

of Twenty-third Street and along the Northwesterly line of said Twenty-third Street to a point at the intersection of the Northwesterly line of said Twenty-third Street with the Northwesterly prolongation of the Northeasterly line of Palm Avenue, thence Northwesterly along said Northwesterly prolongation of the Northeasterly line of said Palm Avenue to a point in the Northerly boundary line of the City of Huntington Beach, thence Westerly along the said Northerly boundary of the City of Huntington Beach to the Quarter Section line running North and South through Section Four (4), Township Six (6) South, Range Eleven (11) West, thence S. 40° 36′ W. to the ordinary high water mark of the Pacific Ocean, thence Southeasterly along said ordinary high water mark of the Pacific Ocean to the point of beginning, subject to easements, rights-of-way and other matters of record,

in accordance with the rules and regulations of the State now promulgated, and such reasonable rules and regulations of the State as may be promulgated hereafter; from those certain lands hereinbefore referred to as the State lands, belong to the State of California, situate in the County of Orange, State of California, and more particularly described as follows, to wit:

47 An area of land lying between the extension southwesterly of the center line of 23rd Street in the City of Huntington Beach as said center line is shown on a map entitled "Resurvey of part of Section 34, T. 5 S., R. 11 W., and part of Sections 3, 4, and 10 of T. 6 S., R. 11 W., S.B.M., as per Stearns Rancho Company's Sectionized Survey by Captain T. C. Healey, Surveyor, surveyed by L. G. B. McDowell, field work completed September 15, 1927," filed at page 28 of Book 3 of Maps in the office of the Recorder of the County of Orange and a line extending S. 40°, 36′ W. from a 2″ pipe corner of survey set by V. J. Rowan at the north end of the most westerly course of Lot E as shown upon the above described map and between the ordinary high water mark of the Pacific Ocean and a line parallel to and distant one mile S. 40° 36′ W. from the said ordinary high water mark containing 835 acres, more or less.

48 for a term of twenty (20) years from and after the date hereof, with the option to the Grantee to continue the term of this agreement as to all wells drilled or producing at the expiration of the term hereof, for so long as oil or gas is produced from such wells.

Section 2. The Grantee in consideration of the foregoing hereby agrees:

(a) To furnish a bond in favor of the State of California, and approved by the State in the penal sum of $25,000.00 to guarantee the faithful performance by the Grantee of the terms, covenants and conditions of this agreement and of the provisions of the Act.

(b) To commence operations for the drilling of wells into the State lands, and to thereafter continue with such drilling in accordance with the drilling program, attached hereto, marked Exhibit "A", and by reference made a part hereof.

(c) To pay to the State of California a royalty in accordance with the formula, marked Exhibit "B", attached hereto, and by reference made a part hereof, on the oil produced and saved from each well producing from the State lands or on demand the State's percentage of oil produced in accordance with said Exhibit "B", the royalty when paid in money shall be calculated upon the reasonable market price of the production at the well as determined by the State Lands Commission, which price shall not be greater than the highest price at which a major oil company then buying oil of like gravity in substantial quantities from the Huntington Beach, California, oil field, is offering for oil of like gravity and kind at the well, and shall be due and payable not later than the 25th day of each calendar month following the calendar month in which produced, or when paid in kind, to be delivered in the field and taken by the State at the receiving tanks of the Grantee located upon the uplands on forty-eight (48) hours' notice of the Grantee that a tankful of oil will be ready for delivery; to pay to the State of California at the times and in the manner herein specified for the payment of royalty on oil, 15% of the market value, at Huntington Beach, California, of all dry gas, natural
49 gasoline and other products extracted and saved from the gas produced from the State lands. Unless such dry gas, natural gasoline or other products are sold pursuant to a sales contract approved by the State, the market value shall be the reasonable market value as fixed by the State.

The State may take its royalty dry gas and natural gasoline in kind at its option, delivery thereof to be made at the natural gasoline manufacturing plant where produced or at such other place as the parties hereto may agree.

(d) To pay to the State annually in advance as rental the sum of one (1) dollar per acre for each acre of State lands herein described, which rental shall be credited against the royalties, if any, as they accrue for the year for which such rental is paid.

(e) To file with the State true and correct copies of all sales contracts for the disposition of oil, gas and other hydrocarbon substances produced hereunder and in the event the State should

elect to take such oil or gas royalty or other hydrocarbon substances in money instead of kind, not to sell or otherwise dispose of the oil, gas or other hydrocarbon substances hereunder, except in accordance with such sales contracts or other method first approved in writing by the State.

(f) To furnish monthly statements in detail in such form as may be prescribed by the State, showing, with respect to the wells, the amount, gravity, and market price at the well of all oil produced, saved and sold, the amount of gas produced, saved, and sold and the amount of natural gasoline extracted by the Grantee therefrom during the preceding calendar month, and the number of days each well is on production as the basis for computation of royalties due the State; to keep full and complete records and accounts of the cost of development and the cost of production of oil and gas derived from the wells drilled by the Grantee into the State lands, which said records and accounts shall be available at all reasonable times to the inspection and examination of any person authorized by the State; to an examination of books and records of any individual, association, or corporation which has transported for or received from the Grantee any oil, gas or other hydrocarbon substances produced from the State lands, and to gasoline extracted from gas produced therefrom; to permit inspection at all reasonable times, by any person authorized by the State, of the operations of the Grantee with respect to the wells, improvements, machinery and fixtures used in connection therewith.

(g) To make logs and surveys of all wells drilled by the Grantee into the State lands in accordance with the provisions of this agreement and in accordance with approved current practices of operations of this character in effect at the time of undertaking of such operations, and to file as confidential information all such logs and surveys and also all records of well cores and other related information with the Division of Oil and Gas of the Department of Natural Resources of the State of California; to waive the statutory limitations upon the use by the State, or a duly authorized employee of the State, of any such information filed with said Division of Oil and Gas by the Grantee. Any and all information filed by the Grantee with the said Division of Oil and Gas shall be available at all times to the State for the purpose of forcing compliance with the terms, covenants, and conditions of this agreement and rules and regulations now promulgated by the State, and reasonable rules and regulations which may hereafter be promulgated by the State.

(h) To pay when due all taxes lawfully assessed and levied under the laws of the State, County, City, and United States of America, upon improvements, oil, gas, and other hydrocarbon substances produced from the State lands, other than taxes upon the State's royalty oil, gas, and other hydrocarbon substances; to accord all

maintenance or operations on the part of the Grantee and the officers, agents and employees of the Grantee.

(n) Not to assign, transfer, or sublet to any person, association of persons, or corporation, who does not possess the qualifications provided in the Act; and not to assign, transfer or sublet to any other person, association of persons, or corporation without the prior consent in writing of the Commission; should the Grantee at any time during the term hereof be adjudged a bankrupt, either upon Grantee's voluntary petition in bankruptcy, or upon the involuntary petition of Grantee's creditors, or any of them, or should an attachment be levied and permitted to remain for an unreasonable length of time upon or against the interest, rights or privileges of Grantee in or to any oil, gas or other hydrocarbon substances produced from any well or wells drilled by Grantee upon said lands, then all of the interests, rights, and privileges of Grantee in and to all oil,
54 gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, shall immediately cease, terminate and end, and in such event the State shall have, and Grantee, by the acceptance thereof, hereby gives the State, the right, option and privilege to cancel and terminate this agreement and all of the terms and provisions granted hereby, and all of the rights and privileges of Grantee in and to or upon the State lands, and in and to any oil, gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, and all of Grantee's rights and privileges granted by this Agreement shall immediately cease and terminate and end upon the State so exercising its option in writing.

(o) To pay to the State the State's royalty share of any bonus received by the Grantee from the sale of any oil, gas or other hydrocarbon substances produced hereunder.

Section 3. The State expressly reserves:

(a) The right to grant easements or crossings in, upon and under the State lands, and nothing herein contained shall be construed as limiting the powers of the State of California to lease, convey, or otherwise transfer or encumber, during the life of this agreement, the State lands for any purpose whatsoever not inconsistent or incompatible with the rights or privileges granted in this agreement to the Grantee; and further there is hereby specifically reserved from the operations under this agreement any and all rights and privileges heretofore granted by the State of California as set forth in those Agreements for Easements Nos. 278, 279, 281, 282, 284, 286, 318, 336, 338 and 340, Huntington Beach, now on file with the State.

(b) The right to take its royalty oil, natural gasoline or dry gas in kind by giving notice of thirty (30) days to the Grantee of the State's intention so to do, and upon such election the State shall continue to take its said royalty oil, dry gas or natural gasoline (as the case may be) in kind for a period of six months from the time it commences to take such royalty oil, dry gas or natural gasoline (as the case may be) in kind, and thereafter for like periods of six (6) months unless the State shall at least thirty (30) days prior to the end of any such six (6) months period,
55 notify the Grantee in writing of the State's election to cease taking its royalty oil, dry gas or natural gasoline (as the case may be) in kind, and to take the same in money.

Section 4. The State or the Grantee shall have the right to use any or all of the surplus gas of the Grantee for the purpose of repressuring the field of which the State lands are a part; and the State, at its option, shall be entitled to take, at no expense to the Grantee, and without payment of compensation to the Grantee therefor, for the use of the State of California; all remaining surplus gas, which cannot be marketed by the Grantee at a reasonable price.

Section 5. That the Grantee may use oil or gas produced from the wells upon the State lands, or gas received currently in exchange for such gas so produced, for fuel purposes for necessary operations of the wells in State lands, for the drilling of new wells into the State lands, for re-circulation of any of the wells, or for repressuring the oil sand or sands from which any such well may be producing, even though such gas is injected into such sand through another well the bottom of which is in lands of the State of California, free from any royalty charges thereon.

Section 6. If and when it should become necessary to dehydrate or clean the oil produced from wells drilled into the State lands, the Grantee shall be entitled to compensation from the State of California of actual cost but not to exceed 2½¢ per barrel of net royalty oil so dehydrated or cleaned, or at such other rate per barrel as the parties hereto may mutually agree.

Section 7. After having been reduced to posession, the posession by the Grantee of the State's royalty portion of oil, gas and gasoline shall be as trustee for the State until full settlement for the royalty interests to the State have been made. Grantee shall be empowered to sell and convey good title to the full amount of the State's royalty oil, gas and gasoline produced and saved if and when such sales have been approved in writing as herein provided.

56 Section 8. The Grantee may run all oil produced from the State lands to central storage tanks located either upon

EXHIBIT 9

EXHIBIT 9

SOUTHWEST

EXPLORATION

RATION

COMPANY

STATE OF CALIFORNIA EASEMENT 392

ALIFORNIA EASEMENT 392

PARTICIPATION
PAULEY GROUP
HUNTINGTON BEACH CO
PACIFIC ELECTRIC LAND CO
PACIFIC ELECTRIC R R CO

PARTICIPATION
PAULEY GROUP
HUNTINGTON BEACH CO
PACIFIC ELECTRIC LAND CO
PACIFIC ELECTRIC R R CO

PARTICIPATION
PAULEY GROUP
BOLSA LAND CO

PARTICIPATION
BOLSA LAND CO

PARTICIPATION
BOLSA LAND CO

HUNTINGTON BEACH CITY BOUNDRY

ORDINARY HIGH WATER

STANDARD OIL COMPANY - LESSEE
PACIFIC ELECTRIC LAND COMPANY - FEE OWNER
PACIFIC ELECTRIC RAILWAY COMPANY

COMPANY - LESSEE
COMPANY - FEE OWNER
RAILWAY COMPANY

MARK

OCEAN AVE

23RD ST

SOUTHWEST EXPLORATION COMPANY
LOCATIONS

STANDARD OIL COMPANY - LESSEE
HUNTINGTON BEACH COMPANY - FEE OWNER

BOLSA LAND CO FEE OWNER
PACIFIC ELECTRIC RAILWAY CO FEE OWNER
CITY BOUNDRY
SOUTHWEST EXPLORATION CO SURFACE LOCATIONS

SOUTHWEST EX
HUNTINGTON BEACH
MAP OF MA
SHOWING WELLS COMP
DATE SEPT 27, 1950
DRAWN BY L.C.G.

SOUTHWEST EXPLORATION CO.
HUNTINGTON BEACH OFFSHORE AREA
MAP OF MAIN ZONE
SHOWING WELLS COMPLETED DEC 31, 1945
DATE SEPT 27, 1950
REVISED DATE
REVISED DATE
DRAWN BY L.C.G.
LEGEND
TOTAL DEPTH OF WELL
STANDARD OIL CO WELL
SCALE
0 100 200 300 400 500

workmen and employees freedom of purchase, and to pay wages due workmen and employees in accordance with the laws of the State of California and of the United States of American relating to employment of workmen; to comply with all laws of the State
51 of California and all rules and regulations of any agency of the State of California having jurisdiction therein; and all laws of the United States of America, and all rules and regulations of any agency of the United States of America having jurisdiction therein, and all valid ordinances of cities, and counties, applicable to the Grantee's operations, including, without limitation by reason of the specification thereof, the Grantee's compliance with the Act of the State of California creating the office of the State Oil and Gas Supervisor, Statutes of 1915, page 1404, and all amendments thereto.

(i) To exercise reasonable diligence consistent herewith in the operation of said wells while the products therefrom can be obtained in paying quantities and not to unreasonably or unnecessarily suspend continuous operations except with the consent of the State. To carry on all operations hereunder in good workmanlike manner in accordance with approved methods, having due regard for the prevention of waste of oil and unreasonable waste of gas developed through the said wells of the Grantee, or the entrance of water through the said wells of the Grantee to the oil sands or oil bearing strata to the destruction or injury of the oil deposits, or future productive operations and the health and safety of workmen and employees; to plug securely, in the manner prescribed by any agency of the State having jurisdiction thereof, any of said wells of the Grantee, before abandoning the same so as to effectively stop the flow of water from the oil and gas bearing strata; to conduct all drilling and related productive operations hereunder subject to the inspection of authorized officials of the State; to furnish to the State detailed drawings of all pipe lines in any manner attached to the said wells and to report changes or additions promptly; to gauge all oil, to measure all gas, whether dry or wet, in accordance with the rules and regulations now or which may hereafter be promulgated by the State, provided, the State shall have, at any time, the right to gauge all oil and measure all gas, and in the event of a disagreement between the State and the Grantee concerning the quality and quantity of the oil and gas so gauged or measured, the burden to establish the incorrectness of such gauging and measure-
52 ment shall rest upon the Grantee, and the Grantee is hereby given the right to establish, by proper court proceedings, the correct quality and quantity of such oil and gas so gauged and measured; to carry out at the expense of the Grantee all reasonable orders and requirements of the State relative to prevention of unreasonable waste and preservation of the property and the health and safety of workmen, and on failure so to do the State, through

its agent or agents, shall have the right to enter on the uplands of Grantee, and with facilities, tools, equipment and supplies of the Grantee, to repair or prevent such unreasonable waste at Grantee's cost; to abide by and conform to the rules and regulations in force at the time this agreement is executed, covering matters referred to in this paragraph, and to comply with such reasonable rules and regulations as may from time to time be issued by the State, or any other agency of the State having jurisdiction therein; provided, however, that the Grantee shall not be responsible for delay or casualties occasioned by a cause beyond the control of the Grantee.

(j) That the State shall have the right to restrict by appropriate rules and regulations the spacing of wells and the rate of drilling and production of such wells so as to prevent the waste of oil and gas and promote the maximum economic recovery of oil and gas from, and the conservation of reservoir energy in, each zone or separate underground source of supply of oil or gas covered in whole or in part by this agreement, and further that the State may issue rules and regulations which may be amended from time to time to effectuate the purpose of this subsection and in connection therewith restrict the rate of production from any such zone or separate underground source of supply to that provided by Federal or State laws or rules or regulations thereunder, or by any reasonable conservation or curtailment plan ordered by the Commission or agreed to by a majority of the total production from any such zone or underground source of supply.

53 (k) That operations shall be conducted in such manner to prevent pollution and contamination of the ocean and tidelands and all impairment of and interference with bathing, fishing or navigation in the waters of the ocean adjacent to the uplands, and no oil, tar, residuary products of oil, or any refuse of any kind from any well or works of the Grantee shall be permitted to be deposited on or pass into the waters of the ocean adjacent to the littoral lands or uplands.

(l) That each well drilled pursuant to the terms of this agreement shall be slant drilled from the uplands to and into the subsurface of the State lands. Derricks, machinery, and any and all other surface structures, equipment and appliances shall be located only upon the uplands and all surface operations shall be conducted therefrom.

(m) To assume and does hereby assume all liability for personal injuries and property damage resulting from the maintenance and operations of the wells of the Grantee and shall at all times hold the State free and harmless from any liability of the State of California, its officers, agents and employees on account of any negligent

the uplands or other lands in the vicinity, from which said oil may be run to pipe line, after having been measured and tested and net volume computed, and gravity determined. Grantee may run such portion of the oil produced from the State lands which may require dehydration or cleaning to a central dehydration or cleaning plant and after cleaning and dehydration may run such oil to said central storage tanks.

Grantee shall measure separately by proper devices the oil produced from each of said wells, and at approximately regular intervals, at least once in each week of seven days, Grantee shall take samples and make tests of the oil produced from each of said wells to determine the net volume thereof. Such measurements and tests shall be used as a basis for allocating to each of said individual wells the net oil run to pipe line from said central storage tanks.

The Grantee shall meter all gas transported from the State lands and such meter readings, together with analysis of the gasoline content of said gas, made at approximately regular intervals at least once in each month shall furnish the basis for computation of the amount of gasoline and residue gas deemed to have been extracted and saved from gas produced.

Section 9. The Grantee, at any time after drilling offset wells required to be drilled under this agreement, may quitclaim this agreement as to all of the State lands embraced herein or as to any part or parts thereof, and in the event of a partial quitclaim, Grantee's obligations hereunder as to the number of wells (other than offset wells) to be drilled shall be reduced proportionately; provided however, that Grantee shall be obligated to make payment of all rents, royalties and other obligations due and payable to the State accrued to the date of such quitclaim; and further, provided, however, that in the event Grantee quitclaims a portion of the State lands such portion quitclaimed shall be in a compact form and not less than ten (10) acres; and further, provi[redacted] that
57 the Grantee at the request of the State shall grant to any lessee or subsequent grantee of such quitclaimed area, upon such terms and conditions as the State may prescribe, a right to the free use with Grantee of rights of way, easements, or other interests in the State lands acquired by this agreement, as may be necessary or convenient in connection with the operations in such quitclaimed area under a lease or subsequent easement.

Section 10. The obligations of the Grantee hereunder shall be suspended while the Grantee is prevented or hindered from complying therewith in part or in whole by strikes, lockouts, acts of God, laws, rules and regulations of any Federal, State, Municipal or other governmental agency, or other matters beyond the control

of Grantee, whether similar to the matters herein specifically enumerated or not.

Section 11. This agreement may be terminated, and any of the provisions hereof may be modified or amended, upon the mutual consent of the parties hereto.

Section 12. All notices herein provided to be given or which may be given by either party to the other shall be deemed to have been fully given when made in writing and deposited in the United States mail, registered and postage prepaid, and addressed as follows:

(To the State)

State Lands Commission
Department of Finance
State Building
Los Angeles, California.

and

(To the Grantee)

The addresses to which the notices shall or may be mailed, as aforesaid, to either party, shall or may be changed by written notice given by such party to the other as hereinabove provided; but nothing herein contained shall preclude the giving of any such notice by personal service.

58 Section 13. If the Grantee shall fail to comply with the provisions of the Act so far as applicable or make default in the performance or observance of any of the terms, covenants and stipulations hereof, or of the rules and regulations of the State now promulgated, and all reasonable rules and regulations which may hereafter be promulgated, and such default shall continue for the period of thirty (30) days after written notice thereof to the Grantee, and no steps shall have been taken within that time, in good faith, to remedy said default, then the State may enter upon the premises of the Grantee and take possession of the same and all facilities, tools, equipment and supplies for the purpose of operating said wells of the Grantee until such time as all money defaults of the Grantee to the State have been fully satisfied, or if such default cannot be satisfied by the payment of money, then the State shall have the right and power to cancel this agreement or to close said well or wells which are not being conducted or operated in the manner prescribed by the provisions of this agreement, the rules and regulations of the State now promulgated, and reasonable rules and regulations of the State which may be hereafter promulgated; but this provision shall not be construed to prevent the exercise by the State of any legal or equitable remedy which the State

might otherwise effect. The waiver of or failure of the State to act upon any particular cause of forfeiture shall not prevent the cancellation and forfeiture of this agreement for any other cause of forfeiture or for the same cause occuring another time.

Section 14. It is further covenanted and agreed that each obligation herein shall extend to and be binding upon, and every benefit hereto shall inure to, the heirs, executors, administrators, successors and assigns of the respective parties hereto. Singular shall include the plural whenever applicable, and the neuter gender shall include the feminine and masculine, and vice versa, whenever used in this agreement.

59 In Witness Whereof, the parties hereto have executed, or caused to be executed, this agreement the date and year first above written.

State Lands Commission of the
State of California, Party
of the First Part.

By WEBB SHADLE

Southwest Exploration Company
Party of the Second Part.

By E. J. SIEPE,
President.

(Seal)

By CHAS. M. JOHNSON,
Secretary.

Form Approved:

——— ———,
Attorney General of California.

60 Endorsement by Uplands Owner

The owner or owners of real property described in this agreement as the "uplands" hereby acknowledge that the Grantee named in this agreement has been granted all necessary rights-of-way and easements, in and through the uplands necessary for the performance upon the part of the Grantee of the covenants, and the observance upon the part of the Grantee of the conditions, herein set forth, and the said owner or owners hereby consent to all operations upon the uplands specified and contemplated by the provisions of this agreement.

Huntington Beach Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Huntington Beach Company
By M. E. LOMBARDI, (Seal)
Vice President.
By G. M. FOSTER,
Assistant Secretary.

Pacific Electric Railway Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Pacific Electric Railway Company
By O. A. SMITH,
President (Seal)
By L. A. LOVELL,
Secretary.

Pacific Electric Land Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Pacific Electric Land Company
By O. A. SMITH,
President.
By L. A. LOVELL, (Seal)
Secretary.

Standard Oil Company of California executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Standard Oil Company of California
By R. K. DAVIES, (Seal)
Vice President.
By LEE LAIRD,
Assistant Secretary.

Bolsa Land Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Bolsa Land Company
By H. W. KELLER, *Pres.* (Seal)
By ROBERT N. FRICK,
Secretary.

Bolsa Chica Gun Club executes the foregoing for itself and to the extent of its right, title and interest in said uplands.
Bolsa Chica Gun Club
By E. O. MCLAUGHLIN,
V-Pres. (Seal)
By JAMES PAGE,
Secy.

61 Exhibit "A" (For entire tract)

Grantee shall commence drilling operations for the drilling of two wells within thirty (30) days from and after the date of this agreement, and shall thereafter continuously operate not less than two drilling outfits until Grantee has offset certain wells now drilled on the uplands known as the Pacific Electric Right of Way, being the wells of Standard Oil Company of California and known as "P.E." wells numbered "17", "16", "19", "20", "21", "22", "23", "24", "25", "26", "2", and also Standard Oil Company Bolsa well number "31"; each offset well shall be so drilled that all of the perforated or producing portion thereof shall be located less than 350 feet seaward from the ordinary high water mark of the Pacific Ocean. The perforated or producing portion of each offset well shall be so located as to reasonably offset each of said wells herein required to be offset by Grantee, and in all cases the perforated or producing portion of each such offset well shall be located in such "staggered" position that there shall be one well within each strip bounded by straight lines drawn at right angles to the line of said ordinary high water mark through the surface location of each of the upland wells of the Standard Oil Company of California above described. In the event Grantee does not elect to drill a well to offset the now existing well of Standard Oil Company of California known as well numbered Bolsa "31", or in the event said Bolsa "31" should be abandoned, Grantee may quitclaim the offset location thereto and be relieved of its obligation with reference thereto in accordance with provisions governing quitclaim contained in this agreement.

After Grantee has completed the drilling of all offset wells herein provided to be drilled, it shall continue drilling (subject to the right of quitclaiming as provided in this agreement) with at least two drilling outfits (commencing its first well at the easterly side of the State lands) until Grantee has drilled into the State lands
62 a total of eighteen (18) wells, including offset wells. Thereafter, Grantee shall continuously operate at least one drilling outfit until Grantee has drilled into the State lands a total number of wells equal to the nearest whole number obtained by dividing the total acreage of the State lands herein described by ten (10).

The Grantee shall, however, be entitled to drill as many additional wells as Grantee desires.

Each offset well drilled pursuant to the within requirements shall be drilled so that it shall be bottomed in and produce from the same producing horizon as the well being thereby offset.

In the event additional wells are drilled upon and bottomed within the upland strip lying between the southwesterly boundary of Ocean Avenue and the line of the ordinary high water mark of the Pacific

Ocean, or within a strip 175 feet wide along the northeasterly side of Ocean Avenue, provided no well has previously been drilled adjacent thereto southwesterly of Ocean Avenue, or in the event wells drilled from any other surface location are bottomed under said upland strips, and such well produces oil and gas in commercial quantities, then the next well to be drilled hereunder by Grantee shall be located and drilled so as to reasonably offset any such additional well so drilled or bottomed.

In the event, at any time, should any well drilled upon or bottomed within either of the two upland strips herein described be drilled to a deeper or plugged to a shallower separate and distinct producing oil zone or zones, and such well produces oil and gas in commercial quantities, Grantee shall within thirty (30) days thereafter commence operations for the drilling, deepening, or recompleting of a well to such deeper or shallower zone to offset such deepened or recompleted well and shall thereafter so offset each such deepened or recompleted well so drilled or bottomed. Grantee shall have and is hereby given the right to drill as many wells to any such deeper or shallower zone or zones (in addition to offset wells) as Grantee may elect.

63 The term "drilling operations" as used herein is hereby defined to be the construction of a derrick and other necessary structures for the drilling of an oil or gas well and the penetration of the ground with a drilling bit.

64 The oil royalty which the Grantee shall pay to the State shall be according to the following formula:

$$R = \frac{P - 36.67}{2.5 + .16667P} \times 1.1$$

where R is the royalty rate in per cent applicable to the total value of the production of oil from each well during the month, and

P is the average daily production of the well, determined by dividing the total production for the month by the total number of production days of twenty-four hours each;

provided, however, the Grantee shall pay at all times a minimum royalty of twelve and one-half (12½) per cent upon such average daily production.

INSTRUCTIONS TO BIDDER

The last term of the above equation shall be inserted by the bidder to establish the oil royalty which the bidder shall pay to the State.

(Here follow 2 photos, fols. 65, 66)

1. The lands hereinafter in this agreement referred to are described as follows:

That certain area of land situate in the County of Orange, State of California, being a portion of those certain lands referred to as "State Lands," belonging to the State of California in "Exhibit A" of agreements dated August 25, 1938, between Huntington Beach Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corporation, parties of the first part, collectively referred to as "Permittors," and Southwest Exploration Company, a corporation, party of the second part, referred to as "Permittee" more particularly described as follows:

Beginning at the point of intersection of the ordinary high water mark of the Pacific Ocean with the southwesterly prolongation of the center line of Twenty-third Street in the City of Huntington Beach, as said center line is shown on a map entitled "Resurvey of Part of Section 34, Township 5 South, Range 11 West, and Part of Sections 3, 4, and 10 of Township 6 South, Range 11 West, S.B.B.&M., as per Stearns Rancho Company's Sectionized Survey by Captain T. C. Healey, Surveyor, Surveyed by L. G. McDowell, Field Work Completed September 15, 1927," filed at page 28 of Book 3 of Maps in the office of the Recorder of the County of Orange; thence from said point of beginning,

Northwesterly along the ordinary high water mark of the Pacific Ocean to its intersection with the north and south center line of Section 4, Township 6 South, Range 11 West, S.B.B.&M.; thence

South 40° 36′ West 5280 feet to the southwesterly boundary of said State Lands; thence

Southeasterly in a direct line to a point South 40° 36′ West 5280 feet from the point of beginning; thence

North 40° 36′ East 5280 feet to said point of beginning;

Being a portion of the lands described in State Easement referred to above.

2. The term "net profits" as used in this agreement and as applied at any particular time, shall mean the amount by which the "gross proceeds," as hereinafter defined, derived by Southwest from its operations on or in said herein described lands, up to that time, shall exceed the "chargeable expenses," as hereinafter defined, paid and incurred by Southwest up to the same time in connection with such operations.

69

3. The term "gross proceeds" as used in this agreement shall mean and include:

(a) The "sale value," as hereinafter defined, of all oil and other hydrocarbon substances (other than gas and gasoline) produced and saved by Southwest from said herein described lands, exclusive of royalty oil and of other hydrocarbon substances (other than gas and gasoline), delivered in kind to the State of California as its royalty share of such oil and other hydrocarbon substances;

(b) The sale value of one hundred per cent (100%) of all gas produced and saved and sold by Southwest from said herein described lands, including the sale value (computed at the same price at which gas is contemporaneously produced and sold from said herein described lands) of any gas retained by any processor under the provisions of any processing agreement which Southwest may enter into for the processing of gas produced from the herein described lands, exclusive, however, of any royalty gas delivered in kind to the State of California;

(c) The "sale value", as hereinafter defined, of fifty per cent (50%) of all gasoline extracted from gas produced from said herein described lands, exclusive of royalty gasoline delivered in kind to the State of California as its royalty share of the gasoline extracted from gas;

(d) All sums received as rental for materials, supplies, equipment, or facilities, the cost of which has been included within "chargeable expenses" hereunder, rented to others during the term of said State Easement, together with the value of all of said materials, supplies, equipment, or facilities removed from the herein described lands or from said uplands for purposes other than rental, together with the then reasonable market value of all materials, supplies, equipment, or facilities remaining at the time of abandonment or termination of said State Easement, if used thereafter by Southwest, or if not so used, then the actual proceeds at the time of ultimate sale;

(e) The value of any benefits, refunds, credits, returns, or discounts received by Southwest because of its operations upon or in connection with herein described lands.

4. (a) The term "sale value" of all oil, asphaltum, and other hydrocarbon substances (other than gas and gasoline), as used herein, is hereby defined to mean the value thereof computed at the current price posted and paid therefor by Standard Oil Company of California from time to time to producers generally for products

67 EXHIBIT 11

This Agreement, dated the 27th day of September, 1938, by and between *Southwest Exploration Company*, a corporation, Party of the First Part, hereinafter referred to as "Southwest," and *Pacific Electric Railway Company*, a corporation, and *Pacific Electric Land Company*, a corporation, hereinafter collectively referred to as "Pacific Electric," and *Huntington Beach Company*, a California corporation. Said Pacific Electric and Huntington Beach Company are hereinafter referred to as "Second Parties."

Witnesseth:

That, whereas, by two agreements dated the 25th day of August, 1938, Second Parties and others gave Southwest, its successors and assigns, upon the terms and conditions therein provided, certain easements, rights, and rights of way therein specifically set forth, over and through certain uplands, provided Southwest's application to the State of California for a State Easement for the extraction of oil, gas, and other hydrocarbon substances from certain State lands was granted; and

Whereas, the said application was granted by the State of California, and Southwest is the owner and holder of an interest under that certain Agreement for Easement dated the 26th day of September, 1938, between the State of California, through its State Lands Commission, and Southwest, as Grantee, hereinafter referred to as "State Easement," being Agreement for Easement No. 392, and by this reference made a part hereof, whereby the State of California granted to Southwest an easement through, in, and under the lands described in said State Easement, comprising approximately 835 acres, and therein referred to as "State Lands," together with the right to drain, take, receive, extract, remove, and produce from said State Lands, oil, gas, and other hydrocarbon substances through certain wells to be drilled, operated, and maintained by Southwest in the manner provided in said State Easement, the tops of which such wells shall be located on the lands described and referred to in said State Easement as "uplands"; and

68 Whereas, it is the desire and intention of the parties hereto to provide a manner of computation and distribution of rental for the rights and privileges given by Second Parties and others to Southwest in said agreements dated the 25th day of August, 1938:

Now, therefore, for a good and valuable consideration, the receipt of which by Southwest is hereby acknowledged, it is agreed as follows:

EXHIBIT 10

EXHIBIT 10

SOUTHWEST EXPLORATION

TION

COMPANY

STATE OF CALIFORNIA EASEMENT 392

FORNIA EASEMENT 392

PARTICIPATION
PAULEY GROUP
HUNTINGTON BEACH CO
PACIFIC ELECTRIC LAND CO
PACIFIC ELECTRIC R R CO

ARTICIPATION
ULEY GROUP
NTINGTON BEACH CO
CIFIC ELECTRIC LAND CO
CIFIC ELECTRIC R R CO

PARTICIPATION
PAULEY GROUP
BOLSA LAND CO

PARTICIPATION
BOLSA LAND CO

PARTICIPATION
BOLSA LAND CO

HUNTINGTON BEACH CITY BOUNDARY

ORDINARY HIGH WATER MARK

STANDARD OIL COMPANY - LESSEE
PACIFIC ELECTRIC LAND COMPANY - FEE OWNER

COMPANY - LESSEE
COMPANY - FEE OWNER

OCEAN AVE

PACIFIC ELECTRIC RAILWAY COMPANY

RAILWAY COMPANY

MARK

BOLSA LAND CO FEE OWNER

PACIFIC ELECTRIC RAILWAY CO. FEE OWNER

BOLSA LAND CO FEE OWNER

CITY BOUNDARY

SOUTHWEST EXPLORATION CO SURFACE LOCATIONS

23RD ST

SOUTHWEST EXPLORATION COMPANY SURFACE LOCATIONS

STANDARD OIL COMPANY - LESSEE
HUNTINGTON BEACH COMPANY - FEE OWNER

SOUTHWEST EXPLORATION CO.
HUNTINGTON BEACH OFFSHORE AREA
MAP OF JONES ZONE
SHOWING WELLS COMPLETED DEC 31, 1949

DATE OCT 27, 1950
DRAWN BY L.C.S.
REVISED DATE
REVISED DATE

LEGEND
TOTAL DEPTH OF WELL
STANDARD OIL CO WELL

SCALE
0 100 200 300 400 500

as Standard Oil Company Bolsa Well No. 31, be and the same is hereby suspended upon the following conditions, to-wit:

1. That should Standard Oil Company Bolsa Well No. 31 be produced at any time in the future, the Grantee shall immediately commence operations for the drilling of a well in the tidelands and land well and continue with diligence until completion of said well, or

2. That the Grantee, upon thirty (30) days notice in writing from the State Lands Commission to Grantee, shall immediately commence operations for the driling of a well in the tidelands and submerged lands adjacent, and in the position of an offset well to said Standard Oil Company Bolsa Well No. 31, and shall continue operations with diligence until completion of said well.

In all other respects said Agreement for Easement No. 392, Huntington Beach, shall remain unchanged and in full force and effect, except insofar as the same has been heretofore amended or modified by written agreement between the parties hereto.

In Witness Whereof, the parties hereto have caused this agreementt to be executed the date and year first above written.

State Lands Commission
State of California,
First Party,
By WEBB SHADLE, *Attorney*,
Division of State Lands.
Southwest Exploration Company,
a corporation, Second Party
By H. J. MARCH, *President*
By ——— ———, *Secretary*.

(Here Follows 2 Photos, fols. 80, 81)

of like character, gravity, and quality in the same vicinity.

70 (b) The term "sale value" of gasoline, as herein used, is hereby defined to mean the value thereof computed at the current prices paid therefor by Standard Oil Company of California, or any of its present or future subsidiaries, from time to time to producers generally for products of similar specifications, vapor pressure, and quality in the same vicinity.

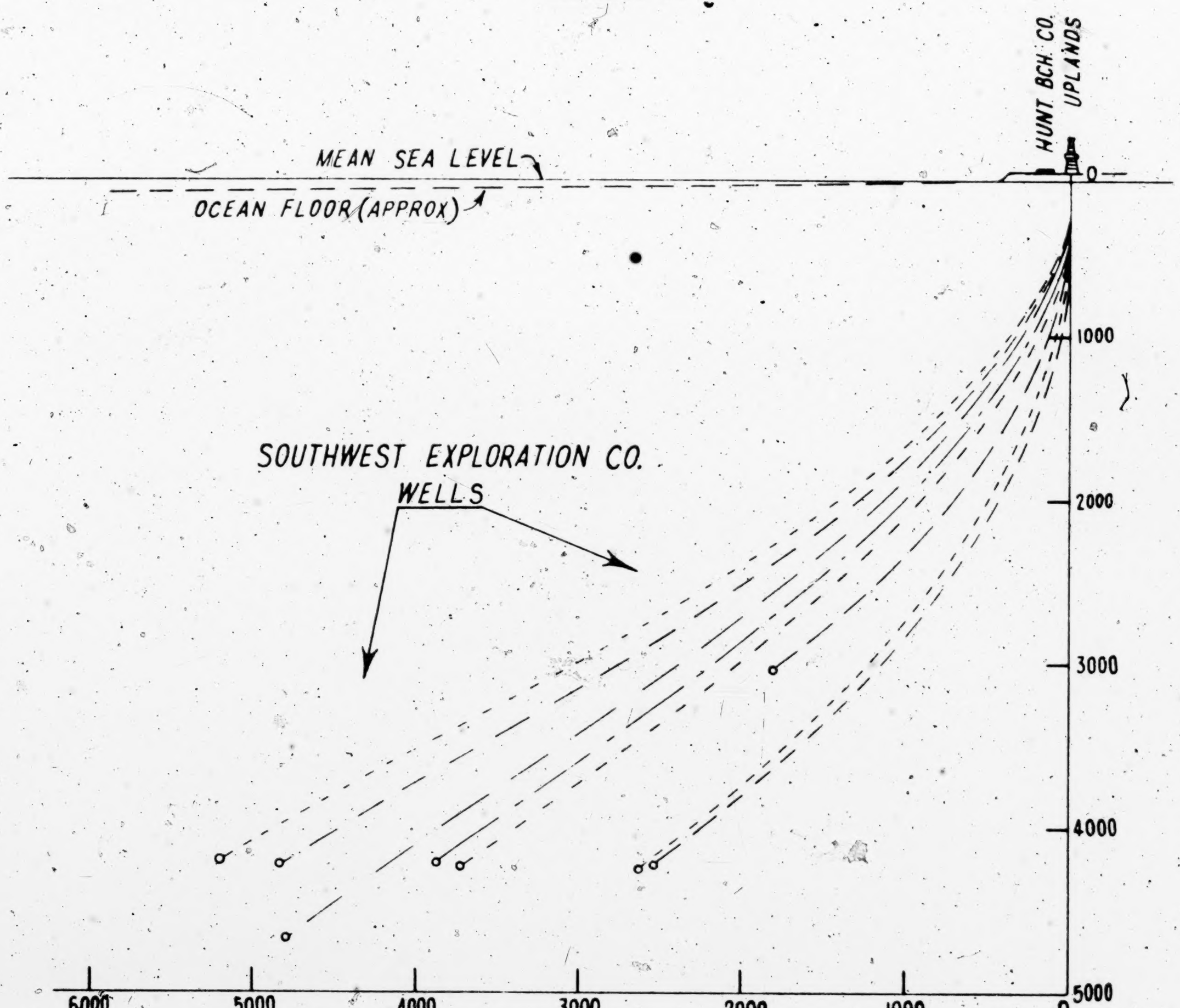
5. The term "chargeable expenses," as used in this agreement, shall mean and include:

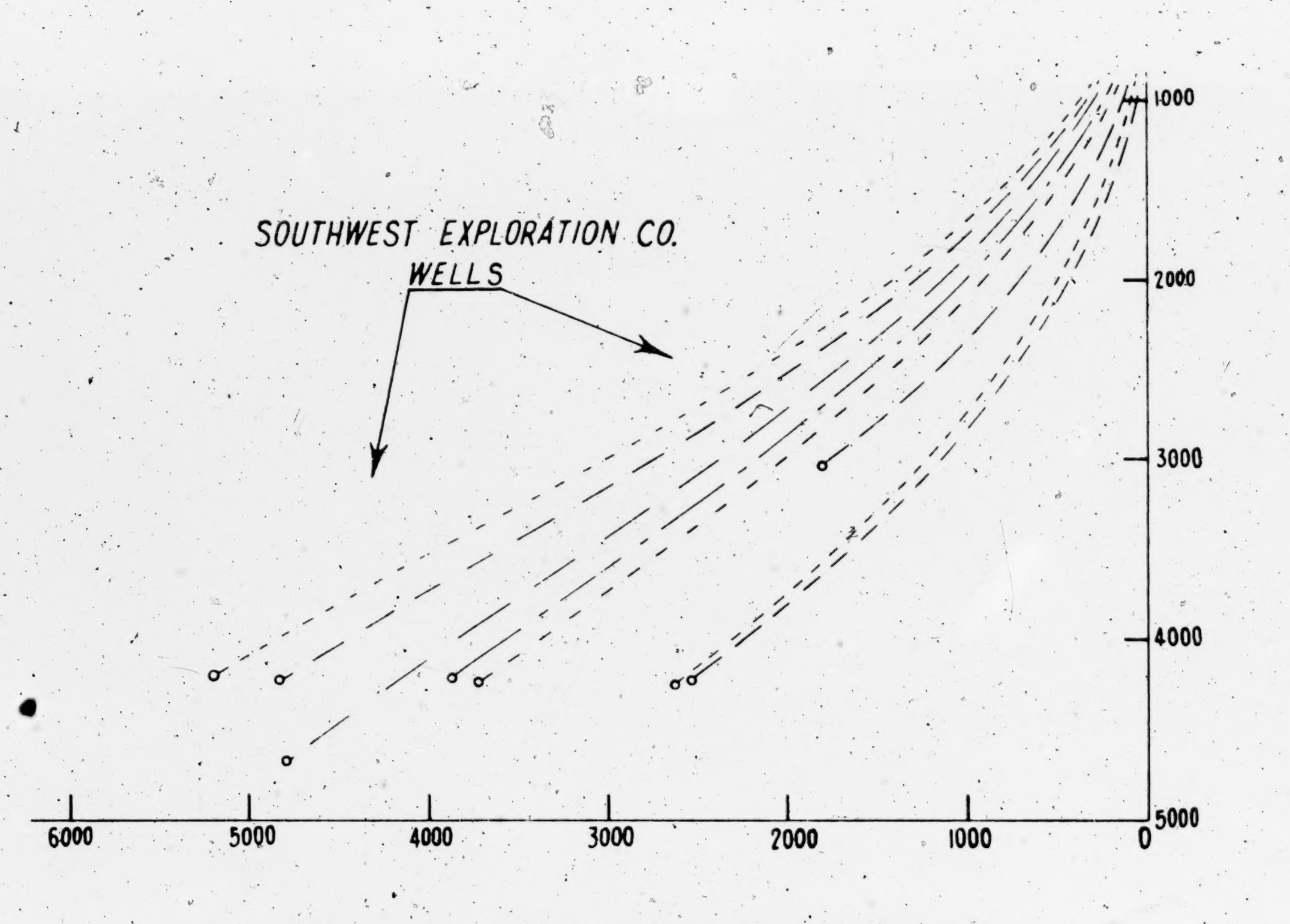
> The entire cost and expense to Southwest of equipping, developing, and operating said herein described lands, and of drilling for, producing, cleaning, and transporting to shipping or stock tanks, including costs of delivering oil from Southwest's storage into pipe lines or other transportation facilities of purchaser, oil, gas, and other hydrocarbon substances from said herein described lands.

Without in any way limiting the generality of the foregoing, "chargeable expenses" shall include:

> (a) All operating expenses which shall include the erection of structures for the drilling and operation of oil wells and the storing of oil (including foundations and all necessary production structures), the drilling, maintenance, pumping, cleaning out, repairing, deepening, and redrilling of all wells, together with the cleaning of oil, construction and maintenance of roads and other means of access of pipe and power lines of every character from time to time necessary, of transportation of every nature, payments of claims for damages (except such claims as are paid out of funds impounded under paragraph 5(d) hereof), costs of litigation, including attorneys' fees, caused by or resulting from operations under said State Easement to the extent applicable to the lands herein described, and without limitation by reason of the specific recitals herein enumerated, any expenditures reasonably appropriate to the proper handling and development of the lands herein described, and of the oil and gas, or either of them, therefrom, and accounting, stenographic, and clerical help in connection with said operations. The charge made by Southwest for supervision and management shall not include any executive or office expenses other than those applicable to the conduct of operations on the lands herein described and incurred by Southwest in the conduct of its field office now located upon lands described in said agreements of August 25, 1938.
>
> (b) To the extent applicable to the lands herein described, all taxes and other charges paid by Southwest; premiums on

EXHIBIT 14





DIAGRAMATIC CHART SHOWING WELLS SURFACED ON HUNTINGTON BEACH COMPANY PROPERTY UPLANDS AND DRILLED BY SOUTHWEST EXPLORATION COMPANY INTO TIDE AND SUBMERGED LANDS COVERED BY STATE EASMENT 392.

any and all bonds required; insurance of all kinds, and any court costs, reasonable attorneys' fees, and any other expenses as may be reasonably incurred for the protection or defense or continuance of the rights, title or interest of Southwest in and to the property herein described as against claims of others. The taxes herein referred to may be prorated monthly over the twelve months of the taxable year, subject to correction when actually paid.

71 (c) To the extent applicable to the lands herein described, all sums, rentals, and royalties paid in money by Southwest to the State of California under the provisions of said State Easement, and all moneys and/or royalties paid by Southwest to the City of Huntington Beach required to be paid under the provisions of that certain agreement made as of the 3rd day of November, 1938, between Southwest, as party of the first part, and City of Huntington Beach, a municipal corporation, as party of the second part, reference to which is hereby made for further particulars.

(d) In the event actual pending claims exist for damages alleged to have been caused by the operations herein referred to, a reasonable sum as a reserve for the payment of such claims; provided that such reserve fund shall be deposited in a special account in a bank or trust company, and shall not be used except for payment of such claims; upon payment of such claims out of said reserve fund, any excess over said claims shall become a part of "gross proceeds."

It is understood and agreed that Southwest is presently operating only the properties herein described under the provisions of said State Easement, and has no office, branch, or place of business other than upon the lands described in those said agreements dated August 25, 1938, elsewhere herein referred to, and that "chargeable expenses" shall include all costs and charges incurred in the erection and maintenance of office buildings, warehouses, and other structures used in connection therewith and erected and maintained upon the lands described in said agreements of August 25, 1938. In the event Southwest should at any time engage in any other development work and/or business other than that specifically herein referred to, or shall establish other offices, then and in that event "chargeable expenses" shall not include any item of overhead, charge, or expense in connection with such other development work and/or business or other offices. In the event Southwest shall incur and pay any item or items of expense in connection with the drilling, development, or operation of said herein described lands and other lands, only such proportion of such item or items of expense as may be properly allocable to said herein described lands

shall be included in "chargeable expenses" hereunder. Neither shall "chargeable expenses" include franchise, license, capital stock, income, profit, or other similar corporate taxes of Southwest.

6. Southwest shall have the free use of, and shall not be required to account to Second Parties for, any oil or gas produced from and used by Southwest in its operations pursuant to said
72 State Easement on said herein described lands.

7. Southwest shall keep true and correct books of account showing the production of oil, gas, and gasoline, and other hydrocarbon substances produced during each calendar month from wells drilled by Southwest pursuant to said State Easement, and shall also keep true and correct books, accounts, and records showing all other data necessary or proper for the settlement of accounts between the parties hereto and the proper adjustment of their rights under this agreement. Not later than the last day of each calendar month, Southwest shall deliver to Second Parties an itemized written statement showing in detail the production and the "gross proceeds" derived from its operations and the total amount of all "chargeable expenses" paid and incurred by Southwest up to the end of such preceding month; and thereafter not later than the end of such calendar month, Southwest shall deliver to Second Parties similar written statements showing the production and the "gross proceeds" derived and the total amount of "chargeable expenses" paid and incurred during the preceding month.

Said statement of "chargeable expenses" shall be in the same summarized form as Southwest shall prepare such statement for its own use.

8. Southwest shall pay to Second Parties as rental an amount equal to the following percentages of the "net profits":

17.75% to Huntington Beach Company,
1.576% to Pacific Electric Railway Company,
5.174% to Pacific Electric Land Company.

Said rental payments shall be made on or before the 25th day of the month immediately following the time when "net profits" arise in the operations herein referred to. As between Pacific Electric Railway Company and Pacific Electric Land Company, the rental payments hereinabove in this paragraph referred to are determined by the proportion of acreage owned by each as to which said State Easement is granted; namely, Pacific Electric Railway Company, 23.35% thereof; Pacific Electric Land Company, 76.65% thereof, the same being 1.576% and 5.174%, respectively, of the "net profits" hereinabove defined and referred to in Paragraphs 2 and 8 hereof.

73 9. All rental payments to Huntington Beach Company hereunder shall be paid to Huntington Beach Company by

Southwest's mailing or delivering check therefor to Huntington Beach Company at 225 Bush Street, San Francisco, California.

10. All rental payments to Pacific Electric hereunder shall be paid to Pacific Electric by Southwest by mailing or delivering in favor of each company, checks therefor to Pacific Electric at Pacific Electric Building, Los Angeles, California.

11. Second Parties, or any one of them, shall have the right to examine at all times the premises herein described and the work done, and in progress thereon, and the production therefrom, and shall also have the right to inspect the books and records kept by Southwest in relation to said property to ascertain the "gross proceeds" and "chargeable expenses" herein referred to, and the production from said property and the amount shipped therefrom.

12. Southwest shall keep a record of installation of all pipe lines laid by Southwest on Second Parties' premises showing the location of such pipe lines, and give Second Parties, or any one of them, access to such record at all times, and upon the request of Second Parties, or any one of them, shall furnish a copy of such record.

13. It is understood and agreed that nothing herein shall add to, modify, or limit the privileges given to Southwest by Second Parties and others in those certain agreements dated August 25, 1938, or the rights given to Southwest under said State Easement, nor shall any default hereunder by Southwest cause a forfeiture of the rights or privileges given Southwest by Second Parties under said agreements of August 25, 1938.

14. All operations performed by Southwest in connection with the development and operation of said described lands shall be at the sole cost and expense of Southwest, and Second Parties shall not be chargeable with nor liable for any part thereof. None of the amounts paid to Second Parties hereunder shall be returned to Southwest should there be a subsequent loss in the development and operation of said lands, provided that if said State Easement and the
74 privileges given Southwest under said agreements of August 25, 1938, and referred to herein, are terminated otherwise than as provided therein and a loss results to Southwest therefrom, then each Second Party shall repay to Southwest the following percentages of such loss; as to Huntington Beach Company, 17.75%; as to Pacific Electric Land Company, 5.174% and as to Pacific Electric Railway Company, 1.576%; provided that none of Second Parties shall be required to pay, in any event, more than has been received by such Second Party hereunder.

15. Second Parties shall have no right, title or interest in or to any machinery, rigs, pipes, casing or other property or improvements of whatsoever nature belonging to or furnished by Southwest in connection with the development and operation of said within described lands, and Southwest shall have the right to remove at any time,

and from time to time, all machinery, rigs, pipes, casing, and other property and improvements belonging to or furnished by Southwest, provided that upon removal of any of said property, a proper accounting of the value thereof when removed shall be made as hereinabove provided.

16. Any notices or statements to be furnished to any party hereto shall be addressed to such party at its address, as follows:

Southwest Exploration Company,
P. O. Box 270,
Huntington Beach, California.
Huntington Beach Company,
225 Bush Street
San Francisco, California.
Pacific Electric Railway Company,
Pacific Electric Building,
610 South Main Street,
Los Angeles, California.
Pacific Electric Land Company,
Pacific Electric Building,
610 South Main Street,
Los Angeles, California.

17. The Second Parties hereby agree among themselves that neither the fact of the execution of this agreement nor anything contained herein shall in any way be deemed as an admission of any of said parties with respect to the right, title, or interest any or both may have in or to any property concerned herein, or in any manner whatsoever be deemed or used as evidence thereof, or as a basis for the construction thereof, or in any manner whatsoever, or at all, used, employed or taken as a basis for the definition of any such right, title, or interest of the Second Parties, or any of them.

18. Whenever reference is made herein to said State Easement, such reference shall be deemed to mean and include any and all extensions, modifications, or renewals thereof.

19. This agreement shall not be construed to give Second Parties any right, title, or interest in said State Lands or in or under said State Easement, and said Southwest may, at any time, at its election, without any consent or participation by Second Parties, modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof. In the event that Southwest shall assign its interest in State Easement, such assignment shall be made subject to the assumption by the assignee thereunder of all of the obligations of Southwest under this agreement.

20. Southwest shall pay all taxes that may be levied against the improvements, plant, machinery, and personal property owned by it

and located upon any part of Second Parties' premises, including oils and minerals that may be stored upon said property.

21. Each party hereto shall promptly notify all other parties hereto of any judicial proceedings brought to its attention and purporting to affect, or affecting, its position hereunder.

22. This agreement and the two said agreements of August 25, 1938, and any and all rights of Southwest in or to the property covered thereby, shall terminate upon the expiration of said Easement No. 392 or any renewals, extensions, or modifications thereof. Upon such termination, Southwest shall proceed diligently to remove any and all facilities which it may have placed upon said uplands and shall forthwith restore said uplands as nearly as possible to the condition in which said premises existed prior to the commencement of operations thereon by Southwest. Southwest shall immediately upon such termination pay to Second Parties whatever sums of money which may then be due them.

76 23. It is the express intention of the parties hereto not to create a partnership relationship.

24. This agreement shall inure to the benefit of, and shall be binding upon, the parties hereto, their respective successors and assigns.

In Witness Whereof, the parties hereto have executed this agreement.

SOUTHWEST EXPLORATION COMPANY,
By H. J. MARCH,
President.
By R. H. GREEN,
Secretary.

PACIFIC ELECTRIC RAILWAY COMPANY,
By O. A. SMITH,
President.
By L. A. LOVELL,
Secretary.

PACIFIC ELECTRIC LAND COMPANY,
By O. A. SMITH,
President.
By L. A. LOVELL,
Secretary.

HUNTINGTON BEACH COMPANY,
By ——
Vice-President.
By G. M. FOSTER,
Assistant Secretary.

77

EXHIBIT 12

STATE LANDS COMMISSION

STATE OF CALIFORNIA

Amendment to Agreement for Easement No. 392,
Huntington Beach

* * * *

This Agreement Made and entered into this 6th day of December, 1938, by and between the State of California, through the State Lands Commission of the State of California, party of the first part, hereinafter called the State, and the Southwest Exploration Company, a corporation organized and existing unnder and by virtue of the laws of the State of California, with its principal place of business at Long Beach, California, party of the second part, hereinafter called the Grantee, pursuant to the "State Lands Act of 1938" hereinafter referred to as the "Act" and by this reference made a part hereof.

By mutual consent of the parties hereto said Agreement for Easement No. 392, Huntington Beach, is hereby amended to read as follows:

Strike remainder of the sentence contained on page 1, line 17, of Exhibit "A" following the word "angles" and add in lieu thereof the following:

> "to a line intersecting and passing through the surface location of each of the wells of the Standard Oil Company of California above described, located on the Pacific Electric right-of-way."

In all other respects said Agreement for Easement No. 392, Huntington Beach, shall remain unchanged and in full force and effect.

In Witness Whereof The parties hereto have executed, or caused to be executed, this agreement the date and year first above written.

STATE LANDS COMMISSION, STATE OF CALIFORNIA,
Party of the First Part.

By —— —— ——

SOUTHWEST EXPLORATION COMPANY,

By —— —— ——

Party of the Second Part.

78

EXHIBIT 13

STATE LANDS COMMISSION,

STATE OF CALIFORNIA

Amendment Agreement for Easement No. 392
Huntington Beach

* * * *

This Agreement made and entered into this 22nd day of March, 1939, by and between the State of California through the State Lands Commission of the State of California, party of the first part, hereinafter called the State, and the Southwest Exploration Company, a corporation organized and existing under and by virtue of the laws of the State of California, with its principal place of business at Long Beach, California, party of the second part, hereinafter called the Grantee, pursuant to the "State Lands Act of 1938" hereinafter referred to as the Act, and by this reference made a part hereof.

Recital

"Exhibit "A" of Agreement for Easement No. 392, Huntington Beach, requires the Grantee to continuously operate not less than two drilling outfits until Grantee has offset certain wells therein enumerated, among them being Standard Oil Company Bolsa Well No. 31. On March 3, 1939, the Grantee herein made application to the State Lands Commission to suspend requirement for the drilling of a well to offset the said Standard Oil Company Bolsa Well No. 31, representing that the said well was not then being produced. No provision is made in said Agreement for Easement No. 392, Huntington Beach, for suspension of the obligation that the Grantee drill said offset well, however, it now appears there is no necessity to make such offset inasmuch as drainage is not taking place by means of an upland well or wells, and it appears proper to the Commission that said Agreement for Easement No. 392, Huntington Beach, should be amended to permit the Grantee therein to suspend offset requirement until such time as said Standard Oil Company Bolsa Well No. 31 is again placed on production or until the Commission by thirty days' advance notice in writing to the Grantee shall require the Grantee to drill such offset well.

79 Now, Therefore, Witnesseth, It is hereby mutually agreed between the parties hereto that Easement No. 392 is hereby amended whereby the requirement contained in Exhibit "A" of Agreement for Easement No. 392, Huntington Beach, obligating Grantee to drill an offset well to that certain upland well described

HUNTINGTON BEACH COMPANY "UPLANDS"

ST

TWENTY THIRD

COAST

HIGHWAY

MEAN SEA LEVEL APPROXIMATE

W. HUNTINGTON BEACH 1929

SOUTHWEST EXPLORATION CO.
STATE EASEMENT 392
STATE TIDE & SUBMERGED LANDS

W. HUNTINGTON BEACH 1929

SOUTHWEST EXPLORATION CO.
STATE EASEMENT 392
STATE TIDE & SUBMERGED LANDS

WESTERLY LIMITS CITY OF HUNTINGTON BEACH

ILLUSTRATING COURSES OF WELLS SURFACED ON HUNTINGTON BEACH COMPANY UPLANDS AND DRILLED BY SOUTHWEST EXPLORATION INTO TIDE AND SUBMERGED LANDS COVERED BY EASEMENT 392

81

54B

EXHIBIT 15

STATEMENT OF INCOME AND EXPENSE OF SOUTHWEST EXPLORATION COMPANY FROM STATE EASEMENT NO. 392 AND HUNTINGTON BEACH COMPANY SHARE OF THE NET INCOME

	1942	1943	1944	1945	1946	1947	1948
Total Southwest income from State Easement No. 392	$2,624,925.54	$3,396,823.62	$6,158,543.81	$6,849,344.34	$7,253,724.82	$11,078,912.31	$19,148,536.60
Chargeable Expenses	1,185,292.76	1,839,970.87	2,957,144.37	3,142,023.27	3,339,249.02	5,385,448.82	11,834,605.01
Southwest's Net income	1,439,632.78	1,556,852.75	3,201,399.44	3,707,321.07	3,914,475.80	5,693,463.49	7,313,931.59
Amount paid Huntington Beach Co. in accordance with agreement (Exhibit 11)	*295,788.33	276,341.36	568,248.39	658,049.48	694,819.46	1,010,589.79	1,298,222.85

* Includes $40,253.52 for prior year representing adjustment of computation of Natural Gasoline and Natural Gas income.

83 ARGUMENT AND SUBMISSION OF CASE—June 9, 1955.

On June 9, 1955, the case was argued and submitted on the merits by Mr. W. J. McFarland for the plaintiff and by Mr. Hilbert P. Zarky for the defendant.

84 *Opinion of the court by Madden, Judge; concerning opinion by Jones, Chief Judge; findings of fact and conclusion of law.*

In the United States Court of Claims

No. 18-55

Decided July 12, 1955

HUNTINGTON BEACH COMPANY, A CORPORATION

v.

THE UNITED STATES

Mr. W. J. McFarland for plaintiff. Messrs. Sigvald Nielson and Harry R. Horrow, and Pillsbury, Madison & Sutro were on the brief.

Mr. Hilbert P. Zarky, with whom was Mr. Assistant Attorney General H. Brian Holland, for defendant. Messrs. Andrew D. Sharpe, Ellis N. Slack, and Kenneth E. Levin were on the brief.

Mr. Melvin D. Wilson filed a brief for Southwest Exploration Company as *amicus curiae*.

OPINION

MADDEN, *Judge*, delivered the opinion of the court:

The plaintiff owned land near the seashore in California. It granted to Southwest Exploration Company the right to come on its land and drill wells slantwise to reach oil deposits which were beneath the adjoining submerged lands owned by the State. As compensation, Southwest agreed to pay the plaintiff 17.75% of Southwest's net profits from the sale of the oil taken from the wells. During the year 1948 the plaintiff received large sums of money from Southwest under this arrangement. It claimed, but the Commissioner of Internal Revenue denied to it, the right to a depletion deduction on those receipts, under sections 23(m), 53 Stat. 14, and 114(b), 53 Stat. 45, of the Internal Revenue Code of 1939. It paid its corporate income taxes without the benefit of the deduc-

tion, and here sues for the refund of $182,802.98 of taxes and
85 interest which it paid, and for interest on that sum as provided by law.

When the owner of solid minerals or of oil and gas deposits receives money as a result of the mining or production of these commodities, what he receives is treated, for tax purposes, as income, and not as a return upon the sale of a capital asset. But the income is different from interest or rent in that the production of the income depletes the source from which the income is derived. For this reason the tax statutes permit the receiver of such income to deduct, in his tax return, 27½% of his gross income from the production of oil.

When the oil produced or the income from its production is, by the arrangements of the parties, to be divided among two or more persons, the basic reason for the depletion allowance is applicable to each of them in his proper proportion. In the usual arrangement whereby the landowner is to have one-eighth of the oil and the operator is to have seven-eights, the prospect of each for future receipts is dimished as present receipts are obtained. Section 23(m) of the Internal Revenue Code says that in the case of leases the depletion deductions shall be equitably apportioned between lessor and lessee.

Transactions looking to the production of oil and gas have taken a great variety of forms. The landowner leases, reserving a royalty. The lessee may sublease, reserving a royalty. Or he may "assign" his lease, the assignee promising to pay a consideration only out of oil produced, and measured by the amount of production. These are only simple illustrations of the various forms which such transactions take. The statutes do not specifically provide for the application of the depletion allowance to these various forms of transaction. But the Supreme Court of the United States has decided many cases involving the depletion allowance, and has thereby developed principles helpful in the solution of other cases not covered by that Court's decisions.

Southwest Exploration Company, the operator which produced the oil from wells on the plaintiff's land, claimed the depletion deduction on all of the oil income. The plaintiff, at the same time, claimed the deduction on its 17¾% of Southwest's net profits. In order to protect the revenue against the loss which would result if these competing claims to the same deduction were both successful,
86 the Commissioner of Internal Revenue took inconsistent positions and denied the disputed portion of the deduction to both parties. Southwest contested the Commissioner's denial in the Tax Court, and that court held in *Southwest Exploration Co. v. Commissioner*, 18 T.C. 961, that the plaintiff did not possess a depletable interest and that Southwest was entitled to the deduction on

all its gross income from the oil wells during the years 1939 through 1945. The United States Court of Appeals for the Ninth Circuit, in a per curiam opinion affirmed, on the basis of the Tax Court's opinion. *Commissioner* v. *Southwest Exploration Co.*, 220 F. 2d 58. If that decision is correct, the plaintiff cannot prevail in this case. It is not legally permissable for both companies to have the same deduction.

The fact that in the instant situation the plaintiff received a share in the net profits from the production of oil, rather than a share of the oil produced regardless of the expense of production, is not a reason to deny the plaintiff a depletion deduction. In *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, a landowner leased his land for the production of oil and gas in return for a cash bonus, a fractional royalty, and 20% of the net profits realized from the production. The Court held that the lessor was entitled to a depletion deduction on the percentage of net profits payment, as well as on the bonus and the royalty. The Court held that the net profits provision gave the taxpayer an additional economic interest in the oil. The Court, at page 603, said:

> By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment. * * * The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted.

The Court, at page 604, further said, in explaining why no distinction was to be made between a retained royalty interest in gross production, and in the operator's net profits:

> In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of oil.

87 In the language from the *Kirby Petroleum* case first quoted above, the reference to the taxpayer's "capital investment" in the oil in place should be noted. It surely cannot mean that it would make any difference that the land had been bought by the lessor for a song as practically worthless desert land, and with no thought of the possibility that it might be a source of oil. In *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 34, the Court said:

> The cost of that investment to the beneficiary of the depletion under § 114(b)(3) is unimportant. * * * Through retention of certain rights to payments from oil or its proceeds in him-

> self, each of these assignors of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds.

It is apparent that in the Supreme Court's view, the economic interest is the essential thing, regardless of what, if anything, it cost to acquire it.

In the *Burton-Sutton* case, *supra*, the question was whether one G, who was in a chain of title from the original lessor, but who had in turn transferred his rights to another, who had transferred his rights to an operator under a contract requiring the operator to pay 50% of the profits of the operation to G, was entitled to the depletion deduction. The Government, in arguing against the deduction, urged that the decision in the *Kirby Petroleum* case, *supra*, was based on the fact that the taxpayer there had, in addition to his right to a percentage of profits, a right to an oil royalty and a bonus. The Government urged that a right to a percentage of profits, standing alone, should not entitle the taxpayer to the depletion deduction. The Court rejected that argument and said at page 32:

> We do not agree with the Government that ownership of a royalty or other economic interest in addition to the rights to net profits is essential to make the possessor of a right to a share of the net profit the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.

We must, then, determine the nature and extent of the plaintiff's economic interest in the oil from which it derived the income here in question. Under the California law, the oil under the
88 State's submerged lands could not be recovered except by drilling in the upland. As a condition precedent to obtaining a lease from the State to drill for oil, an operator had to obtain the consent of the owner of the upland to such drilling. The plaintiff owned the upland. The Government says in its brief, "The plaintiff is, from a pure legal viewpoint, a stranger to the oil which is being extracted from the submerged lands." From a legal viewpoint, the plaintiff, because of its ownership of the strategic upland, had a legal right to say to the prospective operator, "You cannot produce oil from these lands of the State unless you pay me 17¾% of your net profits." That would seem to mean that the plaintiff, far from being a stranger, was almost as intimately related to the oil as is the ordinary landowner on whose land vertical drilling may be done. An oil operator does not give strangers a percentage, large or small, of his net profits. In this case the plaintiff was in such a legal and geographical position of control with regard to the oil under the

State's submerged lands that it could, and did, in exchange for its consent to the recovery of the oil, require that it be paid 17¾% of the operator's net profits, which in the single year 1948, brought a payment to the plaintiff of $1,298,222.85

Suppose A owns land in fee simple. He grants to a golf club an easement to use the surface of the land for a golf course. Oil is discovered in the neighborhood. A grants to C the oil in the land, reserving a royalty. But C cannot drill upon the land, since to do so would be incompatible with the easement of the golf club. The golf club grants to C the right to drill upon the land, in return for a royalty, or a percentage of net profits. Should C or the golf club get the depletion allowance upon the golf club's receipts from this source?

The golf club never owned the oil in place, nor any right to produce it. What it owned was in interest in the surface of the land of such a nature that no one could recover the oil by usual and economical methods without first obtaining from it the right to use the surface for drilling. The discovery of oil in the neighborhood increased the value of its interest in the surface. Under the royalty agreement which it made with the operator, its
89 income from its interest in the land would rise and fall with oil production. As oil was taken out, its prospects for future income would diminish, because of the depletion of the source of its income.

It would seem that, by any realistic standard, the golf club must be said to have an economic interest in the production of the oil. Its physical and legal relation to the situs of the oil puts it into a position to prevent the production of the oil, or permit its production on prescribed terms. That power gave value to its interest in the land. That value was depleted as the oil was taken out.

We think the plaintiff was in the same situation, with regard to the oil under the water, as was the golf club in our illustration. Its land, being the only available site from which a well could be drilled to reach the oil, was in economic relation to the oil. It could no doubt, have sold its land for a much higher price, after the discovery of oil which could be recovered only though its land. It chose to make the arrangement whereby its return would depend upon the recovery of oil through wells on its land, and its prospects for future return would diminish as the oil was taken out. In all reality, the plaintiff had an economic interest in the oil. The feature that makes this case unique, the fact that the drilling was done slantwise instead of vertically, is surely immaterial.

The cases in which the Supreme Court has held that the taxpayer claiming the depletion deduction did not have the required economic interest are distinguishable. In *Helvering* v. *Elbe Oil Land Co.*,

303 U.S. 372, the taxpayer, the owner of oil land, sold it for a fixed consideration, part of which was paid at once and the balance payable in succeeding years if the purchaser should not elect to abandon the transaction. In addition, the vendor was to receive one-third of the net profits which the transferee might earn after having been fully reimbursed for its expenditure in the acquisition, development, and operation of the property. The money on which the taxpayer sought the depletion deduction was the fixed sum payments it had received. The Court held that the money was income from the sale of the oil and gas properties themselves, and not income from the operation of wells on the property.

90 In *Helvering* v. *O'Donnell*, 303 U.S. 370, the Court held that a taxpayer who had transferred shares of corporate stock to an operating company in return for its promise to pay him one-third of the net profits of its oil operations on certain properties, did not have an economic interest entitling him to the depletion deduction. The taxpayer there, unlike the plaintiff in the instant case, had no relation to or control over the production of the oil before he bought and paid for a right to share the profits. He was, factually and legally, a stranger to the oil property.

In *Anderson* v. *Helvering*, 310 U.S. 404, the taxpayer purchased, for a fixed consideration certain royalty interests, fee interests, and oil payments in designated properties. He paid a part of the consideration in cash, and promised to pay, on the balance, one-half of the proceeds of oil and gas produced from the properties, and one-half of his receipts from the sale of the fee properties. During the taxable year, the taxpayer received income from the production of oil and gas, and paid one-half of it over to his vendor. He sought to exclude these payments from his taxable income. The Court held that he could not do so. If the transferor had been entitled to be paid only out of oil and gas production, it would have continued to have an economic interest in the property. But since it was entitled to be paid also from the sale of the fee interests, the transaction was a sale to the vendee taxpayer and the payments which he sought to exclude from his income were payments on the purchase price.

In *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, the taxpayer had contracts with oil producers to separate the wet gas from the dry gas as it flowed from the wells, thereby producing casinghead gasoline. The taxpayer was to keep two-thirds of the gasoline and give one-third to the oil producers. It claimed the right to depletion deductions with respect to its income from these contracts. The Court denied the claim. It said that though its contracts the taxpayer obtained an economic advantage from the production of the gas, but it had no interest in the gas in place. It would seem that the taxpayer in that case was in a situation com-

parable to one who has a contract to buy oil or gas from producers at the wells, for the purpose of reselling it at a profit. As
91 production falls off, his resales and profits will fall off. But his relation to the production is merely collateral. Before he made his contract, he had no relation to the oil, factual or legal. His contract gave him only somewhat the same kind of an interest in continued production which employees, merchants, homeowners, and others in an oil producing area have in continued production.

For a landowner to have a degree of control over what may be done on neighboring land is not unusual. There is a large body of law relating to *jura in alieno solo.* The recognized natural rights to light and air, lateral support, and the flow of streams exist merely by reason of physical location. Easements, affirmative and negative, are created by grant or by prescription. Restrictive covenants, nearly always negative in nature, are recognized and enforced in equity. All of these are interests, short of ownership, in the land whose use is affected by them. Because of the applicable law, and the location of the plaintiff's land, its economic interest in the oil here in question was just as real and just as legally well-grounded as those in the ordinary cases of rights in the land of another.

Our conclusion is that the plaintiff had an important economic interest in the oil under the State's submerged lands, by reason of its control over the recovery of the oil; that it could have surrendered its control by an outright sale, but instead took in exchange a share of the possible net profits; and that the reasons on which the depletion allowance is based are present in the plaintiff's situation. We will therefore award the plaintiff a judgment for $182,802.98, with interest according to law.

IT IS SO ORDERED.

LARAMORE, *Judge;* WHITAKER, *Judge;* and LITTLETON, *Judge,* concur.

JONES, *Chief Judge,* concurring:

I concur in the foregoing opinion, but with the following added comment:

Ordinarily only the owner of the land in which the oil is located or his assignee has any control over the production of the mineral, and consequently any interest in its extraction from the
92 soil. But here the contracts are conditional and interwoven.

The State of California is the owner of the mineral and the land in which it is found.

If the State, as owner, had made an unconditional lease the economic interest would have been confined to the owner, or the

lessee or any subsequent assignee of any interest or part interest from either of them.

But this was a conditional assignment. The only economic interest the lessee could possibly have was the right to extract and sell oil. To make his contract effective and give it any value or interest whatever, it had to be linked to a contract with plaintiff. Otherwise it would have no life and no value. The State law so provided. The contracts were thus tied together and became a part of the warp and woof of the same garment. Neither of the contracts standing alone was effective.

It took the second contract, that with plaintiff, to make the transaction complete. The two contracts were each part of a larger and more comprehensive contract without which no operations could even have been started. If the maker of one essential contract has no economic interest the maker of the other has none.

WHITAKER, *Judge*, also joins in this concurring opinion.

FINDINGS OF FACT

The court, having considered the stipulation of facts entered into between the parties, and the briefs and argument of counsel, makes the findings of fact as follows:

1. Plaintiff is a corporation duly organized and existing under the laws of the State of California. Its principal office is located at San Francisco, California.

2. On or about May 31, 1949, plaintiff duly filed with the Collector of Internal Revenue, First District of California (subsequently designated as District Director of Internal Revenue, San Francisco, California, and herein sometimes referred to as Collector), its corporate income tax return for the taxable year ended December 31, 1948, prepared in accordance with the accrual method of accounting.

93 3. Plaintiff's corporate income tax return for the taxable year ended December 31, 1948, disclosed ordinary net income in the amount of $1,908,703.91. In arriving at said amount of ordinary net income for normal tax and surtax purposes plaintiff deducted percentage depletion of $357,011.28 on account of payments of $1,298,222.85 received from Southwest Exploration Company, a corporation (hereinafter designated as Southwest).

4. In its corporate income tax return for the taxable year ended December 31, 1948, plaintiff computed and disclosed its corporate income tax liability for such year in the total amount of $724,802.72. The amount of its Federal income tax liability as disclosed by its return was duly paid to the Collector and is not in controversy herein.

5. On December 13, 1950, the Internal Revenue Agent in Charge at San Francisco, California, acting on behalf of the Commissioner of Internal Revenue, proposed an additional income tax liability for the taxable year 1948 in the amount of $457.54. All of said amount of $457.54, together with interest thereon, was duly paid by plaintiff to the Collector on February 21, 1951, and is not in controversy herein.

6. Upon subsequent audit and review of plaintiff's income tax return for the taxable year 1948, the District Director of Internal Revenue, San Francisco, California (formerly the Collector of Internal Revenue and hereinafter referred to as District Director), proposed additional income tax for the taxable year 1948 in the amount of $135,664.29. On December 30, 1954, plaintiff duly paid to the District Director all of said amount of additional tax of $135,664.29, together with statutory interest thereon of $47,138.69.

7. The additional income tax of $135,664.29 for the year 1948, as determined by defendant and referred to in the preceding paragraph, was based upon the disallowance of percentage depletion of $357,011.28 as claimed by plaintiff on the payments received by it from Southwest during the taxable year 1948 in the amount of $1,298,222.85 referred to in finding 3 above.

8. On January 3, 1955, plaintiff timely filed with the District Director a verified claim for refund of income tax for the taxable year ended December 31, 1948, in the amount of $135,664.29,
94 plus interest thereon of $47,138.69, together with interest on said amounts as allowed by law.

9. In accordance with the applicable provisions of the Internal Revenue laws, the Commissioner of Internal Revenue notified plaintiff of the disallowance of its aforesaid claim by registered letter dated January 4, 1955.

10. In 1938 the State of California passed the State Lands Act of 1938, now part of the Public Resources Code dealing with the exploitation of oil deposits from the State tidelands. From August 8, 1938, to August 13, 1938, the State Lands Commission published a notice entitled "Notice of Intention of State Lands Commission to Receive Offers to Enter Into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State Situate in Orange County, California" (hereinafter referred to as the Notice).

11. The legal description in the Notice referred to in finding 10 divided the land into five parcels, designated A, B, C, D, and E. Each parcel was said to contain 167 acres, more or less. The area of tidelands and submerged lands identified in the original Notice as parcels A to E, inclusive, of said Orange County, California, tidelands and submerged lands constituted the entire area covered by State Easement No. 392 which Southwest subsequently

obtained from the State of California in the manner hereinafter set forth.

12. Southwest Exploration Company, a corporation (Southwest), is a corporation organized under the laws of California and was incorporated on June 20, 1933, but remained completely inactive until 1938 Its principal office is located at Los Angeles, California. Prior to the agreements dated August 25, 1938, hereinafter referred to, Southwest did not own, lease, operate or control any of the uplands or littoral lands adjacent to the area referred to in the Notice and subsequently identified as State Easement No. 392:

13. Prior to the transmittal of its bid for State Easement, subsequently identified as State Easement No. 392, Southwest, as Permittee, entered into an agreement for a permit dated August 25, 1938, with Huntington Beach Company, a corporation, plaintiff herein, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, Bolsa Land
95 Company, a corporation, Bolsa Chica Gun Club, a corporation, and Standard Oil Company of California, a corporation, as Permittors. The lands of the Permittors referred to as uplands in the Notice and in the agreement, and more particularly described in the first "whereas" paragraph appearing on page 1 of said agreement constituted all of those lands referred to as littoral lands and uplands in section 1 of Agreement for Easement No. 392 and elsewhere therein, which are more particularly described in section 1 thereof.

14. On August 25, 1938, Southwest also entered into a second agreement with plaintiff and other upland owners setting forth in detail the procedures to be followed by Southwest in conducting operations from the uplands. Southwest was the only bidder for State Easement No. 392.

15. In accordance with the terms and conditions of the Notice, Southwest submitted its bid to the State Lands Commission on August 30, 1938. With its transmittal letter Southwest filed with the State Lands Commission the following documents:

(a) Form of Agreement for State Easement, later identified as No. 392, with date omitted but signed by Southwest through its president and secretary; attached to the said Agreement for State Easement No. 392 were those portions of that agreement appearing at the end thereof entitled "Endorsement by Upland Owners," "Exhibit A (for entire tract)" and "Exhibit B;"

(b) The permit agreement referred to in finding 13;

(c) Cashier's check for $15,000 payable to the Treasurer of the State of California;

(d) Certified copy of resolutions authorizing Southwest's

officers to execute the permit agreement and the agreement for easement referred to in finding 13;

(e) Certificate of ownership showing that all of Southwest's stockholders were residents of the State of California.

Southwest's bid conformed in all respects to the requirements of the State Lands Commission. Southwest furnished the $25,000 bond required by the Agreement for State Easement No. 392.

16. In accordance with the terms and provisions of the State Lands Act of 1938 (Cal. Stats. Ex. Sess. 1938, c. 5) South-
96 west's bid was accepted, and it entered into an Agreement for State Easement No. 392 with the State Lands Commission on September 26, 1938.

17. There were no "filled lands" as that term is used in Article 6 of the State Lands Act of 1938 (Cal. Stats. Ex. Sess. 1938, c. 5) which were situated adjacent or contiguous to or otherwise usable or available in the extraction and exploitation of oil, gas or other hydrocarbon substances from the area constituting State Easement No. 392.

18. An agrement dated September 27, 1938, was made between Southwest, as party of the first part, and Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, and Pacific Electric Land Company, a corporation, as second parties. The agreement of September 27, 1938, supplements the prior agreements of August 25, 1938, between Southwest and the upland owners and provides a manner of computation of the amounts payable to plaintiff and other upland owners in consideration of the rights and privileges given by the upland owners to Southwest in the two agreements entered into on August 25, 1938, referred to in findings 13 and 14. Southwest entered into the agreement of September 27, 1938, with plaintiff and other upland owners in consideration of the rights and privileges granted to Southwest by the upland owners in the agreements of August 25, 1938.

19. Amendments to the Agreements for State Easement No. 392 were duly executed on December 6, 1938, and March 22, 1939, respectively.

20. All surface facilities and operations in connection with and for the drilling of and production of oil and gas from the wells covered by State Easement No. 392 and the tops of all such wells drilled pursuant thereto and in accordance with the terms of Southwest's agreements with the upland owners, during the period here material from which plaintiff received payments from Southwest, computed in accordance with the agreement of the parties dated September 27, 1938, were on upland property owned by Huntington Beach Company, plaintiff herein. Said wells were drilled on a slant toward the ocean and, accordingly, went through and under land owned by

the plaintiff herein and land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company so
97 that the bottoms of said wells were out under the Pacific Ocean.

21. Southwest erected on the lands owned by plaintiff all the ordinary facilities, including its field office, settling and shipping tanks, pipelines, and other equipment and appliances required in connection with its business operations. Under the provisions of State Easement No. 392 it was required that each well be drilled by slant drilling from the uplands to and into the subsurface of the State lands covered by State Easement No. 392. All subsurface operations in connection with the drilling and operation of the wells covered by State Easement No. 392 on account of which plaintiff received payments from Southwest were conducted from and through the land owned by plaintiff herein, and through land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company.

22. Huntington Beach Company, plaintiff herein, and other upland owners, in accordance with the agreements dated August 25, 1938, and the agreement dated September 27, 1938, received payments during the taxable year which were referred to in the September 27, 1938, agreements as "an amount equal to the following percentages of the 'net profits' " from the operation of the wells here involved as shown below:

Huntington Beach Company	17.75 percent
Pacific Electric Railway Company	1.576 "
Pacific Electric Land Company	5.174 "
	24.5 "

23. The following tabulation shows the amount paid to the plaintiff by Southwest in the year 1948, and the manner in which that amount was determined:

1948

Total Southwest Income from State Easement No. 392	$19,148,536.60
Chargeable Expenses	11,834,605.01
Southwest's Net Income	7,313,931.59
Amount paid to Huntington Beach Co. in accordance with agreement	1,298,222.85

24. Under the terms of the Notice issued by the State Lands Commission and referred to in finding 10, each bidder, as a condition precedent to the consideration of his bid for State easement, was required to present evidence satisfactory to the State

98 Lands Commission of his present ability to furnish all necessary sites and rights-of-way without cost or obligation to the State for all operations contemplated under the provisions of the form of bid for State easement to be submitted to the State Lands Commission and any bid not accompanied by such evidence would be rejected by the Commission.

25. The evidence of each bidder's present ability to furnish the above-mentioned sites and rights-of-way had to include (1) an endorsement on the Agreement for State Easement by the owner or owners of the real property described as "uplands" in said agreement that the bidder has been granted all such necessary sites, rights-of-way and easements, and (2) the originals or certified copies of the instrument or instruments vesting in such bidder such sites, rights-of-way and easements.

26. The parties to the August 25, 1938, agreement referred to in finding 13, identified therein as Permittors, were the owners of all of the uplands or littoral lands identified as such in the Notice and the Agreement for State Easement No. 392. Under the terms of that agreement of August 25, 1938, the Permittors granted to Southwest the necessary easements, rights and rights-of-way over, on, and through their uplands for the conduct of Southwest's operations under the form of Agreement for State Easement submitted to the State Lands Commission by Southwest for the extraction of oil, gas and other hydrocarbon substances from the area of State-owned tide and submerged lands described in the Notice issued by the State Lands Commission. The easements, rights and rights-of-way granted Southwest in said agreement by the Permittors remained in effect only during such time as the State easement, or any modification, renewal, extension of, or substitute therefor, was in force and effect.

27. Under the terms of the second agreement referred to in finding 14 executed on August 25, 1938, by the plaintiff herein, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corporation, as upland owners and referred to as Permittors and first parties, and Southwest, as second party, and referred to as Permittee, the parties agree (1) that the surface location and

99 subsurface course of Permittee's wells drilled through the uplands pursuant to the State easement shall be agreed upon by Standard Oil Company of California, a corporation (Standard) and Permittee; (2) that all drilling schedules of Permittee and all redrilling, deepening and other work designed to change the subsurface course or location of Permittee's wells through the uplands shall not be undertaken without Standard's prior approval; (3) that the location of all surface facilities, the quality of all equipment to be used by Permittee in connection with such facilities

and the manner of performing all drilling and other operations by Permittee shall be first approved by the Permittors.

28. That agreement also provided (1) that Southwest (Permittee) should, upon request, furnish Standard, et al., copies of logs, record of well cores, electrical logs or surveys, water entrance surveys, plats and surveys showing the location and course of each and every well drilled by Southwest through the uplands pursuant to the State easement and all other technical information and data concerning said wells. Under the terms of that agreement the rights granted by the Permittors were personal to Southwest, nonassignable without the consent of the Permittors and binding upon the successors and assigns of the parties to said agreement.

29. The Agreement for State Easement No. 392 conformed to the terms and provisions of the State Lands Act of 1938 and granted Southwest an easement to extract, remove and produce from the State lands oil, gas and other hydrocarbon substances through wells to be drilled, operated and maintained by Southwest, the tops of which wells were required to be located on the littoral lands or uplands described in the Notice for bids issued by the State Lands Commission and owned by the parties identified as Permittors in the agreements of August 25, 1938, referred to in findings 13 and 14.

30. On September 27, 1938, Southwest entered into the agreement, referred to in finding 18, with plaintiff and other upland owners. This agreement supplemented the prior agreements of August 25, 1938, and provided a manner of computation and distribution of rental for the rights and privileges given by the upland owners to Southwest in the August 25, 1938, agreements. Under said September 27, 1938, agreement as sole consideration to plaintiff for

100 permission to use its uplands in the manner provided by the August 25 agreements, Southwest agreed to pay plaintiff, as one of the upland owners, an amount equal to 17.75% of the net profits from the extraction of oil and gas from the wells covered by State Easement No. 392.

31. The September 27, 1938, agreement provided for the calculation of net profits as gross proceeds from Southwest's operations in a designated portion of the State lands, minus chargeable expenses, and the gross proceeds included the sale value of all oil produced and saved and all gas produced and sold and 50 percent of all gasoline extracted from gas, minus State reserves, plus proceeds of rentals, etc., the cost of which had been a chargeable expense. Under the provisions of said agreement chargeable expenses included all normal operating costs.

32. Under the applicable provisions of the State Lands Act of 1938 and the corresponding provisions of the Pacific Resources Code and the terms of the Notice, the use of the uplands adjacent to the area covered by the Notice and State Easement No. 392 was neces-

sary for purposes of mineral extraction from said State Easement No. 392, and without the use of the surface of the uplands there could be no extraction of oil and gas from said State Easement No. 392.

33. Through their control over production of oil and gas from State Easement No. 392, the upland owners or their Permittees were the only parties qualified to bid for State Easement No. 392. The plaintiff possessed an economic interest in the production and sale of oil and gas from State Easement No. 392.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes that as a matter of law the plaintiff is entitled to recover and it is adjudged and ordered that plaintiff recover of and from the United States the sum of one hundred eighty-two thousand eight hundred two dollars and ninety-eight cents ($182,802.98) with interest according to law.

101 Clerk's Certificate to foregoing paper omitted in printing.

102 Supreme Court of the United States, October Term, 1955

The United States, petitioner

vs.

Huntington Beach Company, a Corporation

Order allowing certiorari. Filed October 10, 1955.

The petitioner herein for a writ of certiorari to the United States Court of Claims is granted, and the case is transferred to the summary calendar. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE, 1955 365720 878